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CASES AND MATERIALS

ON THE LAW OF

BUSINESS ORGANIZATION

(CORPORATIONS)

SELECTED AND EDITED

By

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and

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Brooklyn

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FOREWORD

TWENTY years ago the Columbia Law School concluded that the study of corporation law had been too severely limited by tradition. It undertook to augment the classic corporations course by adding a new course called "Corporation Finance." In course of time this arrangement was widely accepted in many law schools. As it gained recognition, corporation finance established itself as a branch of coordinate standing with the conventional course in corporations.

Yet, from the beginning, it was clear that there was no real line between the principles of corporation law and the principles applicable to those financial situations which are conventionally a part of the life-experience of most corporations. In time the two courses could and should be integrated.

This collection of materials is an endeavor to accomplish that integration, and to present as a single course of study the basic data of both the conventional corporate field and of corporation finance. Taken together they cover the problems of modern corporation theory and practice with reasonable completeness.

A good course (like a good symphony) has both theme and countertheme.

The law of corporations (including corporation finance) arises out of the conception of private property investment within the outlines of finance capitalism. The historic theme of corporation law is that a corporation is a vehicle for profit-making investment: the handling by a group of corporate directors, officers or controlling interests of money or property turned over to them, for the purpose of carrying on an enterprise primarily designed to make profits. In this sense corporations become a branch of property, and the applicable law ranks coordinately with the law of Trusts. But modern financial and technological development has made the corporation into something extremely important from other aspects as well: a social institution, wielding enormous power, responsible in great part for providing employment, developing technique and resources, supplying necessary goods and services, influencing community development, gravely affecting the lives of great numbers of people, and appreciably influencing sociological and political evolution. In this latter sense the corporation is now a major subject of international controversy. When a Russian propagandist lets drive at "monopoly capitalism," he means precisely the system of production, employment and distribution carried on by large corporations.

It would therefore be unrealistic not to accept, as countertheme, the social and sociological implications of the modern corporate system, though each teacher will develop these aspects according to his own ideas and concepts. For instance, classic corporation law spent a tremendous amount of time on the doctrine of *ultra vires,* of which today

only a vestigial remainder is of practical importance. Historically examined, the principal significance of law of limited powers is that it was an attempt at social control of corporations which failed; and this fact is pointed out.

The controversial questions of management policy today largely derive from the fact that modern corporations are now exerting and encountering social pressures on many fronts. The corporate system not only achieved paramount importance as a vehicle for property, production and investment; it also worked a revolution in property tenure and social organization whose implications are only beginning to be explored. No apology is needed for including in these materials notes and commentary relevant to the sociological as well as to the financial and property aspects of the corporate problem. More likely than not the great legal battles in corporation law in the next generation will be fought in this field, rather than in the financial field as in the past.

The brief discussion of corporate accounting is highly elementary. This is because experience unhappily shows that law students are all too frequently almost illiterate in accounting matters. Considerable experimental work has been done in endeavoring to adapt an appropriate accounting course to law school needs; but the problem seems as yet unsolved. It has to be assumed that only the exceptional student will know the difference between a balance sheet and an income statement, or whether surplus is an asset or a liability, until it is explained to him in a course in corporation law. But lest we unduly blame the student, it may be noted that more than one appellate court has written decisions indicating that some judges suffer almost equal confusion!

Though the editors follow the case method of teaching, they have found it useful to recommend the use by students of textbooks on corporation law, especially in connection with bodies of law which are well settled. The recent edition of Professor Ballantine's textbook on corporation law has proved excellent for that purpose. For students already trained in case reading, time can frequently be saved for more valuable discussion by permitting the student to familiarize himself through textbooks with the settled elementary legal rules. This practise, however, turns on the policy and teaching method pursued by each individual instructor, and it is offered here merely as a record of personal experience.

The editors acknowledge with gratitude the assistance of Dean Young B. Smith who placed many facilities of the Columbia Law School at our service; of Mr. Thorold J. Deyrup and Mrs. Helene Walters, both of the New York Bar, for services in editing, proof-reading and incidental research; and of Messrs. Eugene L. Bondy, Jr., Henry Bartow Farr, and Edgar Carroll Morrison for research assistance in preparing notes.

ADOLF A. BERLE, JR.
WILLIAM C. WARREN.

January 15, 1948

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ON THE LAW OF

BUSINESS ORGANIZATION (CORPORATIONS)

PART I

CREATION OF THE CORPORATION

Whatever the historical origin of the business corporation, there is little question about the theory of its creation and existence in Anglo-American law.

Under the accepted theory, the corporation was created by act of the sovereign (king, Parliament, or, in the United States, legislature). The right to exist as a corporation, and its power to carry on an enterprise, was obtained by grant or "franchise". Each such grant stood on its own bottom. General incorporation laws were unknown until the 19th Century. The grant, not infrequently, was accompanied by privileges other than those of corporate existence: the monopoly to trade in certain areas, or to operate a ferry, or a railroad, between definite points. The grant thus created or empowered the associates to create a legal personality; empowered them also to enter into an enterprise; and, as a general rule, if not in America, indicated the general outline of that enterprise. The policy of the sovereign or state was implicit, or sometimes explicit, in the entire proceeding.

Though the theory has not been seriously overhauled, the hundred years of corporate development from the middle of the 19th to the 20th Century has revolutionized the nature and content of corporate creation. Today special franchises and grants of corporate power are not only not usual, but are forbidden in many states except to highly specialised forms of corporations and these commonly do not have business purposes. In place of the old grant, general corporation laws exist, permitting any number of associates (in New York and Delaware, three as a minimum) to write their own charter, state their own purposes and powers which may be adequate to carry on an indefinite number of wholly diverse operations, to fix

for themselves the capital stock they intend to have, and the characteristics which the shares of stock shall have; and so forth. These agreements, or charters, or certificates of incorporation—the lineal descendants of the old royal or legislative charter—are filed with a state official, usually the Secretary of State. Upon approval by him (which, in practice, means by an official in his office who scrutinizes the documents to see that the statutory form has been complied with), the corporation as a legal personality is authorized to come into existence.

The change in practice obviously has the effect of eliminating any implication that the existence or wording of a charter reflects the state policy—other than the very general state policy permitting business to be done in corporate form. The economic fact is that a corporate charter is an agreement under which associates can invest their money and act as a group in an enterprise and along lines which they themselves or their predecessors devised and accepted. The state may be said to permit this, but can hardly be considered an actor in the proceedings.

There follow, for illustrative purposes, definitions taken from the early commentators and a sample early legislative charter. Occasionally a modern practitioner will run into surviving corporations from this era—several railroad corporations still are in this class. The illustrations contrast with the modern general incorporation acts and charters of today, of which illustration is also given.

A. MAKING THE CONTRACT

1. HISTORICAL-CORPORATE DEFINITIONS

1612—Sutton's Hospital Case, 16 Co.Rep. 23a, 29b (1613).

Coke set out the following elements as necessary for the existence of a corporation:

"1st. Lawful authority of incorporation by 1.) the common law as the king himself, or 2.) authority of Parliament, or 3.) by king's charter; and by prescription."

"2nd. Persons to be incorporated, viz; persons natural, or bodies incorporate and political."

"3rd. Name by which they are incorporated."

"4th. Of a place, for without a place no incorporation can be made."

"5th. By words sufficient in law, but not restrained to any certain, legal, and prescript form of words."

1616—Coke on Littleton 250 a, I Thomas, A Systematic Arrangement of Lord Coke's First Institute of the Laws of England (Robert H. Small, Phila., 1st Am. Ed. from 19th London Ed., 1827) 213:

"A body politic is a body to take in succession, framed (as to that capacity) by policy, and therefore it is called by Littleton a body politic; and it is called a corporation or body incorporate, because the

persons are made into a body, and of a capacity to take and grant, etc. And the body politic, or incorporate may commence, and be established thru manner of ways, viz. by prescription, by letters patent, or by Act of Parliament."

1702—Anonymous, *The Law of Corporations* (Cleve, London, 1702) 1:

"A Corporation or Incorporation is a Body framed by Policy or Fiction of Law, and it's therefore called a Body Politick; and it's called an Incorporation or Body Incorporate, because the Persons are made into a body which endureth in perpetual Succession; and are of Capacity to grant, sue, or be sued, and the like. * * * They cannot speak nor appear in Person but by Attorney.

"The general Intent and End of all Civil Incorporations is for better Government; either general or special. * * *

"Special Government is so called because it is remitted to the Managers of particular things, as Trade, Charity and the like; for Government whereof several Companies and Corporations for Trade were erected. * * *

"But a Corporation, or Body Politick, is not only as a Franchise. A Body Politick, is framed in similitude as a natural Body; with a capacity to take, hold, and enjoy, and act as a natural Body: it is a capacity framed to be and act as one Person. But Franchises, and Liberties of all other Natures are Estates and Inheritances grantable and conveyable from one to another, but a Corporation cannot be so. Other Franchises and Liberties convey either some profit from the King as Felon's Goods, Waifs, Strays, etc. or affect his Subjects, as Courts Gaols, Return of Writs, Fairs, Markets. But this of being a Body Politick, is only a Capacity to be a Person capable of having and holding what may be granted to it."

1766—1 Blackstone *Commentaries On the Laws of England* (George W. Childs, Phila. Sherwood's Ed., 1862) 467:

"* * * it has been found necessary when it is for the advantage of the public to have any particular rights kept on foot and continued, to constitute artificial persons, who may maintain a perpetual succession, and enjoy a kind of legal immortality.

"These artificial persons are called Bodies politic, bodies corporate (corpora corporatu) or corporations: of which there is a great variety subsisting, for the advancement of religion, of learning, and of commerce; in order to preserve entire and forever those rights and immunities, which if they were granted only to those individuals of which the body corporate is composed, would upon their death be entirely lost and extinct."

Page 471: "Corporations by the civil law, seem to have been created by the mere act, and voluntary association of their members; provided such convention was not contrary to law. * * *

"But, with us in England, the king's consent is absolutely necessary to the erection of any corporation, either impliedly or expressly given."

1780—3 Comyns, *A Digest of the Laws of England* (W. Strahan, London, 1780) 397:

"A corporation is a Franchise created by the King.

"A corporation is a Body constituted by Policy, with a Capacity to take, or to do.

"For by Incorporation it acquires *Ius Personae* and becomes *Persona politica* and is capable of all Civil Rights *habendi* and *agendi*".

1793—1 Kyd, *Treatise On the Law of Corporations* (J. Butterworth, London, 1793) 13:

"A corporation, or body politic, or body incorporate is a collection of many individuals united in one body, under a special denomination, having perpetual succession under an artificial form, and vested by the policy of the law, with a capacity of acting, in several respects, as an individual, particularly of taking and granting property, contracting obligations, and of suing and being sued; of enjoying privileges and immunities in common, and of exercising a variety of political rights, more or less extensive, according to the design of its institution, or the powers conferred upon it, either at the time of its creation, or at any subsequent period of its existence".

1819—*Trustees of Dartmouth College v. Woodward,* 4 Wheat. 518 (1819):

"A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the character of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and if the expression may be allowed, individuality; properties by which a perpetual succession of many persons are considered as the same, and may act as the single individual."

1826—2 Kent *Commentaries On American Law* (O. Halstead, N. Y., 1st Ed., 1826) 215:

"A corporation is a franchise possessed by one or more individuals, who subsist as a body politic, under a special denomination, and are vested, by the policy of the law, with the capacity of perpetual succession, and of acting, in several respects, however numerous the association may be as a single individual".

P. 223: "In England, corporations are created and exist by prescription, by royal charter, and by Act of Parliament. With us they are created by authority of the legislature and not otherwise."

1882—Angell and Ames, *Treatise On the Law of Private Corporations* (Little, Brown & Co., Boston, 11th Ed., 1882) 23:

"According to the several definitions we have already offered of a corporation, it means an intellectual body, composed of individuals, and created by law; a body which is united under a common name, and the members of which are so capable of succeeding each other,

that the body (like a river) continues always the same notwithstanding the change of the parts that compose it. * * *

"* * * In the popular meaning of the term, nearly every corporation is public inasmuch as they are created for the public benefit."

TYPICAL SPECIAL INCORPORATION ACT

MASSACHUSETTS LAWS, 1818, CHAPTER CLXXIX

Chapter CLXXIX—February 24, 1818

An act to incorporate the Proprietors of the Maine Flour Mills

Sec. 1. *Be it enacted by the Senate and House of Representatives, in General Court assembled, and by the authority of the same,* That Thomas Agry, John Agry, Chanceller Robbins, and William Oliver Vaughn, all of Hallowell be, and hereby are constituted a corporation and body politic, under the name of the Proprietors of the Maine Flour Mills, for the purpose of manufacturing corn and grain, of every description, into meal and flour; and with power and authority to do, in their corporate name and capacity, all things which are necessarily incident and proper to the purchasing and manufacturing of corn and grain into meal or flour, and vending thereof.

Sec. 2. *Be it further enacted,* That the said corporation be, and the same hereby is authorized and empowered to purchase and hold, in their corporate name, lands and tenements, within the county of Kennebec, not exceeding the value of thirty thousand dollars in the whole, and personal estate, not exceeding the value of twenty-thousand in the whole, which may be suitable and necessary to carry into effect the purposes intended by this act.

Sec. 3. *Be it further enacted,* That the corporate property shall be divided into five hundred shares, at one hundred dollars a share; and that the shares in said corporation shall be considered to be personal estate, and transferable in the same way and manner in which turnpike shares and bridge shares are transferred on the books of the corporation.

Sec. 4. *Be it further enacted,* That the said corporation shall never be indebted, at any one time, in an amount exceeding twenty-five thousand dollars; and that whenever any execution shall issue against such corporation, on any judgment rendered in any civil action, and the said corporation shall not, within fourteen days after demand thereof made upon the President or Treasurer of the corporation, by the officer to whom the writ or execution has been committed to be served, shew to such officer sufficient estate to satisfy such execution, the officer may then levy the same upon the estate of any person or persons who were members of said corporation, at the time when the debt was contracted, for which such execution was issued.

Sec. 5. *Be it further enacted,* That it shall be the duty of said corporation to cause each and every barrel and half-barrel, or other vessel containing flour, or meal, manufactured and prepared for sale, by this corporation, to be branded with the name of the said corporation, durably and legibly; and that the said corporation shall be liable to a penalty of two dollars for each and every barrel of flour which shall be offered for sale, from the manufactory of the said corporation, without having been so branded; and the said penalty may be recovered in any Court having jurisdiction in such cases, with costs, by the Selectmen of the town, in which such manufactory may be situated, for the use of the poor of the town.

Sec. 6. *Be it further enacted,* That if any person or persons shall counterfeit the brand of the said corporation, or use the brand of the said corporation, to mark any barrel or half-barrel, or other vessel containing flour or meal, not manufactured by the said corporation, or its agents or factors, or shall fraudulently use any barrel or half-barrel, or other vessel which may have been lawfully branded by said corporation, and emptied of its contents, such person or persons so offending, shall forfeit and pay the sum of twenty dollars for each and every such offense, to be recovered by action of debt, in any Court proper to try the same; one half of which sum shall be to the use of the person who shall sue for the same, and the other half to the use of the said corporation.

[Approved by the Governor, February 24, 1818.]

LAWS OF THE STATE OF NEW YORK PASSED AT THE THIRTY-SIXTH, THIRTY-SEVENTH AND THIRTY-EIGHTH SESSIONS OF THE LEGISLATURE, VOLUME III—THIRTY-SIXTH SESSION.

Chapter CXLI—Passed April 6, 1813

An Act to incorporate the Lenox Water Company

Whereas Moses H. Cook, together with sundry other citizens, have associated for the purpose of supplying that part of the town of Lenox, in the county of Madison, situated on the Seneca Turnpike road, called Federal Hill, with pure and wholesome water, for the use of such of the inhabitants thereof, and others, as may be inclined to take same: Therefore,

I. *Be it enacted by the people of the state of New York, represented in Senate and Assembly,* That Moses H. Cook, and such others as may become interested in the association or company, formed for supplying that part of the town of Lenox, in the county of Madison, situated on the Seneca Turnpike road, called Federal Hill, with water by means of conduits or aqueducts, shall be and are hereby created and made a corporation and a body politic in fact and in name by the name of the "Lenox Water Company" and by that name shall be capable in law to sue and be sued, plead and be impleaded, in any court of record; but shall not be capable of holding any real estate, excepting such as may be necessary for such conduits or aqueducts, in any other place than in that part of the aforesaid town called Federal Hill aforesaid, or any real or personal estate exceeding the

annual value in the whole, of five hundred dollars, exclusive of the profits or income of such conduits or aqueducts.

II. *And be it further enacted,* That it shall and may be lawful for any three of the said persons so associated, or to be associated, by a notice to be given in writing, at two of the most public places in Federal Hill, five days at least previous to any meeting, to convene the said company or association at the most convenient and public place therein, and such of the members of the said association, being at least a majority of the whole number, as shall so convene, shall be and are hereby authorized by a vote of the majority present, to choose and appoint a treasurer, clerk, and collector of such association, and such other agents as may be necessary to carry into effect the objects of the association; to make and ordain all such by-laws, rules, and regulations, relative to the said conduits or aqueducts as they may be proper and necessary for the superintendence, regulation, and management of the same, and of such as may be added thereto; and for the alteration, preservation, and reparation thereof; or for the equal assessment and collection amongst the proprietors of the same aqueducts, in proportion to their respective rights or shares, of all costs and expenses arising in the execution of all such by-laws, rules, and regulations aforesaid: And further, to institute such suits in the name of such company or association as may be necessary to recover damages that may be done to the said aqueducts, or for any penalty imposed as aforesaid. *Provided,* That no penalty be imposed by virtue of any such by-laws or regulations as aforesaid, shall be contrary to the laws of this state, or exceed twenty dollars for any one offense.

III. *And be it further enacted,* That the said treasurer shall receive and pay out all monies collected by virtue of this act, agreeably to the orders and directions of the said association; and the said clerk shall enter in writing, all the proceedings of the same association or company, when convened as aforesaid, under this act; and the said collector shall levy and collect all such taxes and sums of money so as aforesaid to be voted in pursuance of this act, agreeably to such tax-list or assessment-roll as shall be made out and delivered him by the said clerk, the same being by him first certified and subscribed, and shall pay the same monies over to the treasurer of the said association; and the said collector shall have the like powers, and may proceed in like manner, in the said collection, as is by law prescribed to the collection of any town, in the collection of the contingent charges of the county.

IV. *And be it further enacted,* That all transfers of shares in the said association or company, shall be made and entered in a book to be by them provided for that purpose, under such regulations as may be prescribed by the said association.

NOTE

CORPORATIONS AS "PERSONS"

One result of the doctrine that a corporation was a "fictitious person" probably was entirely unforeseen. The Fourteenth Amendment protecting "persons" against

being deprived of life, liberty, or property without due process of law, was almost absentmindedly extended to corporations. This became an axiom (after the definition of Lewis Carroll in "Sylvie and Bruno": an axiom is a statement which everyone is too polite to deny). It remained for Justice Black in a famous dissenting opinion to challenge the statement.

This dissent is worth considering in all its implications. It has not changed and probably will not for some time change, the established doctrine. Yet it lies there, a thought which can emerge when economic or political pressures pile up.

Even if accepted, there are still individuals—natural persons—involved in the corporation. If the fictitious person is not within the protection of the Fourteenth Amendment, the natural persons nevertheless do have that protection; and to adopt Justice Black's doctrine may merely refer the problem of privation of property to an examination of the circumstances of the natural persons who, however low in visibility, do inhabit this multiple organism known as "the corporation".

CONNECTICUT GENERAL LIFE INSURANCE CO. v. JOHNSON.

Supreme Court of the United States, 1938. 303 U.S. 77, 58 S.Ct. 436.

Mr. JUSTICE STONE delivered the opinion of the Court.

Appellant is a Connecticut corporation, admitted to do an insurance business in California. In addition to its business conducted within that state it has entered into contracts with other insurance corporations likewise licensed to do business in California, reinsuring them against loss on policies of life insurance effected by them in California and issued to residents there. These reinsurance contracts were entered into in Connecticut where the premiums were paid and where the losses, if any, were payable. The question for decision is whether a tax laid by California on the receipt by appellant in Connecticut of the reinsurance premiums during the years 1930 and 1931, infringes the due process clause of the Fourteenth Amendment. * * *

All that appellant did in effecting the reinsurance was done without the state and for its transaction no privilege or license by California was needful. The tax cannot be sustained either as laid on property, business done, or transactions carried on within the state, or as a tax on a privilege granted by the state.

Reversed.

Mr. JUSTICE BLACK (dissenting).

I do not believe that this California corporate franchise tax has been proved beyond all reasonable doubt to be in violation of the Federal Constitution and I believe that the judgment of the Supreme Court of California should be affirmed. Traditionally, states have been empowered to grant or deny foreign corporations the right to do business within their borders, and "may exclude them arbitrarily or impose such conditions as [they] will upon their engaging in business within [their] jurisdiction." * * *

But it is contended that the due process clause of the Fourteenth Amendment prohibits California from determining what terms and conditions should be imposed upon this Connecticut corporation to promote the welfare of the people of California.

I do not believe the word "person" in the Fourteenth Amendment includes corporations. "The doctrine of stare decisis, however appropriate and even necessary at times, has only a limited application in the field of constitutional law." This Court has many times changed its interpretations of the Constitution when the conclusion was reached that an improper construction had been adopted. Only recently the case of West Coast Hotel Company v. Parrish, 300 U.S. 379, 57 S.Ct. 578, 81 L.Ed. 703, 108 A.L.R. 1330, expressly overruled a previous interpretation of the Fourteenth Amendment which had long blocked state minimum wage legislation. When a statute is declared by this Court to be unconstitutional, the decision until reversed stands as a barrier against the adoption of similar legislation. A constitutional interpretation that is wrong should not stand. I believe this Court should now overrule previous decisions which interpreted the Fourteenth Amendment to include corporations.

Neither the history nor the language of the Fourteenth Amendment justifies the belief that corporations are included within its protection. The historical purpose of the Fourteenth Amendment was clearly set forth when first considered by this Court in the Slaughter House Cases, 16 Wall. 36, 21 L.Ed. 394, decided April, 1873 —less than five years after the proclamation of its adoption. Mr. Justice Miller, speaking for the Court, said:

"Among the first acts of legislation adopted by several of the States in the legislative bodies which claimed to be in their normal relations with the Federal government, were laws which imposed upon the colored race onerous disabilities and burdens, and curtailed their rights in the pursuit of life, liberty, and property to such an extent that their freedom was of little value, while they had lost the protection which they had received from their former owners from motives both of interest and humanity. * * *

"These circumstances, whatever of falsehood or misconception may have been mingled with their presentation, forced * * * the conviction that something more was necessary in the way of constitutional protection to the unfortunate race who had suffered so much. [Congressional leaders] accordingly passed through Congress the proposition for the *fourteenth amendment, and * * * declined to treat as restored to their full participation in the government of the Union the States which had been in insurrection,* until they ratified that article by a formal vote of their legislative bodies." 16 Wall. 36, at page 70, 21 L.Ed. 394.

Certainly, when the Fourteenth Amendment was submitted for approval, the people were not told that the states of the South were to be denied their normal relationship with the Federal Government unless they ratified an amendment granting new and revolutionary rights to corporations. This Court, when the Slaughter House Cases were decided in 1873, had apparently discovered no such purpose. The records of the time can be searched in vain for evidence that this amendment was adopted for the benefit of corporations. It is true that in 1882, twelve years after its adoption, and ten years after the Slaughter House Cases, supra, an argument was made in this Court that a journal of the joint Congressional Committee which framed

the amendment, secret and undisclosed up to that date, indicated the committee's desire to protect corporations by the use of the word "person." [11] Four years later, in 1886, this Court in the case of Santa Clara County v. Southern Pacific Railroad, 118 U.S. 394, 6 S.Ct. 1132, 30 L.Ed. 118, decided for the first time that the word "person" in the amendment did in some instances include corporations. A secret purpose on the part of the members of the committee, even if such be the fact, however, would not be sufficient to justify any such construction. The history of the amendment proves that the people were told that its purpose was to protect weak and helpless human beings and were not told that it was intended to remove corporations in any fashion from the control of state governments. The Fourteenth Amendment followed the freedom of a race from slavery. Justice Swayne said in the Slaughter Houses Cases, supra: that: "By 'any person' was meant *all* persons within the jurisdiction of the State. No distinction is intimated on account of race or color." Corporations have neither race nor color. He knew the amendment was intended to protect the life, liberty, and property of *human* beings.

The language of the amendment itself does not support the theory that it was passed for the benefit of corporations.

The first clause of section 1 of the amendment reads: "All *persons* born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside." Certainly a corporation cannot be naturalized and "persons" here is not broad enough to include "corporations."

The first clause of the second sentence of section 1 reads: "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States." While efforts have been made to persuade this Court to allow corporations to claim the protection of *this* clause, these efforts have not been successful.[12]

The next clause of the second sentence reads: "Nor shall any State deprive any *person* of life, liberty, or property, without due process of law." It has not been decided that this clause prohibits a state from depriving a corporation of "life." This Court has expressly held that "the liberty guaranteed by the 14th Amendment against deprivation without due process of law is the liberty of *natural, not artificial persons.*" [13] Thus, the words "life" and "liberty" do not apply to corporations, and of course they could not have been so intended to apply. However, the decisions of this Court which the majority follow hold that corporations are included in this clause in so far as the word "property" is concerned. In other words, this clause is construed to mean as follows:

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11 San Mateo County v. Southern Pacific Railroad, 116 U.S. 138, 6 S.Ct. 317, 29 L.Ed. 589. See, Benj. B. Kendrick, "Journal of the Joint Committee on Reconstruction" (1914, New York); Howard J. Graham, "The 'Conspiracy Theory' of the Fourteenth Amendment," 47 Yale Law Journal 371; Donald Barr Chidsey, "The Gentleman from New York—A Life of Roscoe Conklin," Yale University Press (1935).

12 Selover, Bates & Co. v. Walsh, 226 U.S. 112, 126, 33 S.Ct. 69, 57 L.Ed. 146.

13 Western Turf Association v. Greenburg, 204 U.S. 359, 363, 27 S.Ct. 384, 51 L.Ed. 520.

"Nor shall any State deprive any *human being* of life, liberty or property without due process of law; nor shall any State deprive any corporation of property without due process of law."

The last clause of this second sentence of section 1 reads: "Nor deny to any person within its jurisdiction the equal protection of the laws." As used here, "person" has been construed to include corporations.[14]

Both Congress and the people were familiar with the meaning of the word "corporation" at the time the Fourteenth Amendment was submitted and adopted. The judicial inclusion of the word "corporation" in the Fourteenth Amendment has had a revolutionary effect on our form of government. The states did not adopt the amendment with knowledge of its sweeping meaning under its present construction. No section of the amendment gave notice to the people that, if adopted, it would subject every state law and municipal ordinance, affecting corporations, (and all administrative actions under them) to censorship of the United States courts. No word in all this amendment gave any hint that its adoption would deprive the states of their long-recognized power to regulate corporations.

The second section of the amendment informed the people that representatives would be apportioned among the several states "according to their respective numbers, counting the whole number of *persons* in each State, excluding Indians not taxed." No citizen could gather the impression *here* that while the word "persons" in the second section applied to human beings, the word "persons" in the first section *in some instances* applied to corporations. Section 3 of the amendment said that "no *person* shall be a Senator or Representative in Congress," (who "engaged in insurrection"). There was no intimation *here* that the word "person" in the first section *in some instances* included corporations.

This amendment sought to prevent discrimination by the states against classes or races. We are aware of this from words spoken in this Court within five years after its adoption, when the people and the courts were personally familiar with the historical background of the amendment. "We doubt very much whether any action of a State not directed by way of discrimination against the negroes as a class, or on account of their race, will ever be held to come within the purview of this provision." [15] Yet, of the cases in this Court in which the Fourteenth Amendment was applied during the first fifty years after its adoption, less than one-half of 1 per cent. invoked it in protection of the negro race, and more than 50 per cent. asked that its benefits be extended to corporations.[16]

If the people of this nation wish to deprive the states of their sovereign rights to determine what is a fair and just tax upon corporations doing a purely local business within their own state boundaries, there is a way provided by the Constitution to accomplish this purpose. That way does not lie along the course of judicial amendment

14 Gulf, C. & S. F. Ry. Co. v. Ellis, 165 U.S. 150, 154, 17 S.Ct. 255, 41 L.Ed. 666.

15 Slaughter House Cases, supra.

16 Charles Wallace Collins, "The Fourteenth Amendment and the States" Boston (1912), page 138.

to that fundamental charter. An amendment having that purpose could be submitted by Congress as provided by the Constitution. I do not believe that the Fourteenth Amendment had that purpose, nor that the people believed it had that purpose, nor that it should be construed as having that purpose.

I believe the judgment of the Supreme Court of California should be sustained.

2. MODERN CORPORATION STATUTES

(a) NEW YORK STOCK CORPORATION LAW (ORGANIZATION SECTIONS)

§ 5. *Incorporation.* Three or more persons may become a stock corporation for any lawful business purpose or purposes except to do in this state any business for which a corporation may be formed under or pursuant to the banking law, the insurance law, the railroad law, or the transportation corporations law, by making, subscribing, acknowledging and filing a certificate which shall be entitled and endorsed "Certificate of incorporation of ......, pursuant to article two of the stock corporation law" (the blank space being filled in with the name of the corporation) and which shall state:

1. The name of the proposed corporation.
2. The purpose or purposes for which it is to be formed.
3. Either the amount of the capital stock and the number and par value of the shares of which it is to consist, or, if the corporation is to issue shares without par value, the statements required by section twelve.
4. If the shares are to be classified, the number of shares to be included in each class and all of the designations, preferences, privileges and voting powers of the shares of each class, and the restrictions or qualifications thereof.

If any class of stock which is preferred as to dividends or assets is to be issued in series as provided by section eleven, either (a) the designations, preferences, privileges and voting powers of the shares of the first series of such class, and the restrictions or qualifications thereof, and that the board of directors is authorized to fix from time to time before issuance the designations, preferences, privileges and voting powers of the shares of each subsequent series of such class, and the restrictions or qualifications thereof, or (b) that the board of directors is authorized to fix from time to time before issuance the designations, preferences, privileges and voting powers of the shares of each series of such class, and the restrictions or qualifications thereof.

5. The city, village or town and the county, within the state, in which the office of the corporation is to be located, and the address, within or without the state, to which the secretary of state shall mail a copy of process in any action or proceeding against the corporation which may be served upon him.

6. Its duration.

7. The number of its directors, or that the number of directors shall be not less than a stated minimum nor more than a stated maximum. In either case the number of directors shall be not less than three.

8. The names and post-office addresses of the directors until the first annual meeting of the stockholders, and if such address shall be in a city, the street and number or other particular description thereof. The number of the directors so named must be the number stated pursuant to the last preceding subdivision of this section if a definite number be stated, or, if an indefinite number be provided for, not less than the minimum number.

9. The name and post-office address of each subscriber of the certificate of incorporation, and a statement of the number of shares of stock which he agrees to take. If the address of any such subscriber shall be in a city, the street and number or other particular description thereof.

10. That all of the subscribers of the certificate are of full age, that at least two-thirds of them are citizens of the United States, and that at least one of them is a resident of the state of New York; that at least one of the persons named as a director is a citizen of the United States and a resident of the state of New York.

11. That the secretary of state is designated as the agent of the corporation upon whom process in any action or proceeding against it may be served.

12. If meetings of the board of directors are to be held only within the state the certificate or by-laws must so provide.

(b) DELAWARE GENERAL CORPORATION LAW (ORGANIZATION SECTIONS).

Article IX of the Delaware Constitution

Sec. 1. No corporation shall hereafter be created, amended, renewed or revived by special act, but only by or under general law, nor shall any existing corporate charter be amended, renewed or revived by special act, but only by or under general law; but the foregoing provisions shall not apply to municipal corporations, banks or corporations for charitable, penal, reformatory, or educational purposes, sustained in whole or in part by the State. The General Assembly shall, by general law, provide for the revocation or forfeiture of the charters of all corporations for the abuse, misuse, or non-use of their corporate powers, privileges or franchises. Any proceeding for such revocation or forfeiture shall be taken by the Attorney-General, as may be provided by law. No general incorporation law, nor any special act of incorporation, shall be enacted without the concurrence of two-thirds of all the members elected to each House of the General Assembly.

Sec. 2. No corporation in existence at the adoption of this Constitution shall have its charter amended or renewed without first filing, under the corporate seal of said corporation, and duly attested

in the office of the Secretary of State, an acceptance of the provisions of this Constitution.

Sec. 3. No corporation shall issue stock, except for money paid, labor done or personal property, or real estate or leases thereof actually acquired by such corporation.

Sec. 4. The rights, privileges, immunities and estates of religious societies and corporate bodies, except as herein otherwise provided, shall remain as if the Constitution of this State had not been altered.

Sec. 5. No foreign corporation shall do any business in this State through or by branch offices, agents or representatives located in this State, without having an authorized agent or agents in the State upon whom legal process may be served.

Sec. 6. Shares of the capital stock of corporations created under the laws of this State, when owned by persons or corporations without this State, shall not be subject to taxation by any law now existing or hereafter to be made.

Delaware General Corporation Law

Article 1.

General Provisions Respecting Corporations

Sec. 1. *Purposes for Which Formed:*—Any number of persons, not less than three, may associate to establish a corporation for the transaction of any lawful business, or to promote or conduct any legitimate objects or purposes under the provisions of and subject to the requirements of this Chapter as hereinafter provided, excepting for such purposes as are excluded from the operation of the general law by Section 1 of Article 9, of the Constitution of this State, upon making and filing a Certificate of Incorporation in writing in manner hereinafter mentioned. Corporations for constructing, maintaining and operating public utilities outside of this State, may be formed under the general provisions of this Chapter, but corporations for constructing, maintaining and operating public utilities within this State shall be subject to the special provisions and requirements of this Chapter applicable to such corporations.

Sec. 5. *What Certificate Shall Set Forth:*—The Certificate of Incorporation shall set forth:

1. The name of the corporation which name shall contain one of the words, "association", "company", "corporation", "club", "incorporated", "institute", "society", "union", "syndicate", or "limited", or one of the abbreviations, "co.", "corp.", "inc.", or "ltd.", and shall be such as to distinguish it upon the records in the office of the Secretary of State from the names of other corporations organized under the laws of this State.

2. The name of the county and the city, town, or place within the county in which its principal office or place of business is to be located in this State, and the name of its resident agent which agent may be either an individual or a corporation. In towns or cities of over six

thousand inhabitants, the street and number of such principal office or place of business shall be stated, and the address by street and number of said resident agent shall be stated. Should such resident agent be not a resident of, nor located in, an incorporated town or city, then the hundred of its or his location or residence, and postoffice address, shall be stated.

3. The nature of the business, or objects or purposes to be transacted, promoted or carried on.

4. If the corporation is to be authorized to issue only one class of stock, the total number of shares of stock which the corporation shall have authority to issue and (a) the par value of each of such shares, or (b) a statement that all such shares are to be without par value; or, if the corporation is to be authorized to issue more than one class of stock, the total number of shares of all classes of stock which the corporation shall have authority to issue and (a) the number of the shares of each class thereof that are to have a par value and the par value of each share of each such class, and/or (b) the number of such shares that are to be without par value, and (c) a statement of all or any of the designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, which are permitted by the provisions of Section 13 of this Chapter in respect of any class or classes of stock of the corporation and the fixing of which by the Certificate of Incorporation is desired, and an express grant of such authority as it may then be desired to grant to the Board of Directors to fix by resolution or resolutions any thereof that may be desired but which shall not be fixed by said Certificate. In each case the Certificate of Incorporation shall also set forth the minimum amount of capital with which the corporation will commence business, which shall not be less than one thousand dollars. The foregoing provisions of this paragraph shall not apply to corporations which are not organized for profit and which are not to have authority to issue capital stock. In the case of such corporations, the fact that they are not to have authority to issue capital stock shall be stated in the Certificate of Incorporation. The conditions of membership of such corporations shall likewise be stated in the Certificate of Incorporation or such Certificate may provide that the conditions of membership shall be stated in the by-laws.

5. The names and places of residence of each of the incorporators.

6. Whether or not the corporation is to have perpetual existence, if not, the time when its existence is to commence and the time when its existence is to cease.

7. Whether or not the private property of the stockholders, or in the case of a corporation which is to have no capital stock, if the members of such corporation, shall be subject to the payment of corporate debts, and if so, to what extent.

8. The Certificate of Incorporation may also contain any provision which the incorporators may choose to insert for the management of the business and for the conduct of the affairs of the corporation, and any provisions creating, defining, limiting and regulating the powers of the corporation, the directors and the stockholders, or any class of the stockholders, or, in the case of a corporation which is to have no

capital stock, of the members of such corporation; provided, such provisions are not contrary to the laws of this State. * * *

10. The Certificate of Incorporation may also contain such provisions as may be desired limiting or denying to the stockholders the preemptive right to subscribe to any or all additional issues of stock of the corporation of any or all classes.

11. The Certificate of Incorporation may also contain provisions requiring for any corporate action the vote of a larger proportion of the stock or any class thereof than is required by this Chapter.

Sec. 7. *When Corporate Existence Begins:*—Upon making the certificate of incorporation and causing the same to be filed, and a certified copy thereof recorded as aforesaid, and paying the license tax therefor to the Secretary of State, the persons so associating, their successors and assigns, shall from the date of such filing be and constitute a body corporate, by the name set forth in said certificate, subject to dissolution as in this Chapter elsewhere provided.

Sec. 11. *First Meeting:*—The first meeting of every corporation shall be called by a notice signed by a majority of the incorporators named in the Certificate of Incorporation designating the time and place of the meeting, which place may be either within or without this State, and stating the purpose for which such meeting is called; and such notice shall, at least two weeks before the time of any such meeting, be published three times in some newspaper of the County where the corporation may be established or have its principal place of business, or said first meeting may be called without such publication of notice, if two days' notice be personally served on all the parties named in the certificate of incorporation, or if all the parties named in the certificate of incorporation shall, in writing, waive notice and fix a time and place of meeting, then no notice or publication whatever shall be required of such first meeting.

Sec. 12. *By-Laws:*—The original by-laws of a corporation may be adopted by the incorporators. Thereafter, the power to make, alter or repeal by-laws shall be in the stockholders, but any corporation may, in the certificate of incorporation, confer that power upon the directors.

3. MODERN CORPORATE ORGANIZATION PAPERS: THE CONSTITUTIVE DOCUMENTS

NOTE

THE FORMAL CONTRACT CREATING A CORPORATION

It has been observed above that charters evolved from the royal or legislative grant, implying policy, to formal contracts permitted and sanctified by the state. The sanctification is accomplished by filing the documents in an appropriate office, usually that of the Secretary of State, and performing certain other prescribed formalities. The following statutes give the requirements of formal organization and the scope of permission (which is extremely broad) extended to the parties who form the corporation.

A thoughtful person immediately will note that the actual parties in interest commonly do not appear at the incorporation stage. Three incorporators sign the certificate, writing in it the powers that they desire to have. In point of fact, the real stockholders do not emerge until later,—they subscribe for or buy the stock thereafter. They do not enter as contracting parties—at least in form—in any relationship with the state. Yet they are contemplated at the very time that the corporation is formed. The persons working up the incorporation papers necessarily have this in mind. Possibly indeed they may have duties towards the persons they expect to invite into the corporation as future stockholders: See Hayward v. Leeson (post, p. 929).

THE CORPORATE POWERS AND THE CORPORATE ENTERPRISE

Analysis of a certificate of incorporation and an incorporation act will disclose that a corporation has, among others, two distinct functions.

a. Operations

Since every business corporation is formed for the purpose of exploiting some enterprise, it must have power to do all the physical acts and make all of the legal arrangements necessary or convenient in connection with this enterprise. Hence the elaborate charter powers permitting a corporation to buy or sell, own land, operate power plants, or whatever may fall within the field of the work of the corporate operating staff.

b. Distribution of interests (Finance)

Likewise, the corporation must provide a mechanism by which capital is secured for its operations, which necessarily involves arrangements for distributing periodically to the contributors of capital the profit of the enterprise, and for distribution of the net assets of the concern in case of its dissolution and winding up. This latter function is distinctly a financial one; and requires determination of the property interests of the participants.

Historically, this latter function was extremely simple. Originally, corporations had only one class of stock. This stock had a par value so that the contribution of capital made by each shareholder was defined, or, at least, a minimum contribution was stated, in the certificate of incorporation. As soon as such stock was paid for it was "issued" to the subscriber (original purchaser from the corporation) and thus became "outstanding" (as distinguished from stock authorized to be issued but still unissued). The property interests could then be determined by a simple process of arithmetic, i. e., dividing the profits or net assets by the number of shares outstanding. The management of the corporation (board of directors and responsible executive officers) had no discretion in defining these interests.

Evolution of modern business has, however, blurred this distinction; indeed, it is now difficult, if not impossible, to separate the two functions. Thus, a corporation conducting an enterprise desires to buy an additional plant. In order to secure the money to do this, it seems necessary to add to the number of shares of stock outstanding, and to issue the additional stock to the owners of the plant in lieu of the purchase price. Buying and running the new plant is obviously a matter of operation. But the issuance of additional stock necessarily upsets the previous determination of property interests. Thus, if there were 100 shares of stock outstanding prior to the purchase, and the corporation prior to the purchase had $100,000 of net assets, the holder of every share participated to the extent of 1 per cent. of the net assets or $1,000 (known as "book value") and 1 per cent. of the net profits. It is proposed to buy the new plant for 100 additional shares of stock. At once, (1) the interest of each previous shareholder is diminished. He has ½ per cent. interest instead of 1 per cent. in respect of each share held. (2) The book value of his interest in the net assets may be shifted, depending on the valuation of the new plant. If the new plant is fairly worth $50,000 and the direc

tors issue 100 shares of stock for it, each share represents a book value of $750 at the close of the transaction, whereas prior to that time each original share represented $1,000. Conversely, the book value might be increased if the new plant has a value higher than $100,000. The management of the corporation must determine the valuation of the plant; and this function at once permits them to enter the field of determining of property interests, though the form will consist of a resolution by the directors estimating the value of the new plant. At the same time their judgment as to whether the new plant should be added to the scope of the company's operations will turn, at least in part, on precisely this valuation.

As will be seen, when the directors are empowered not merely to issue additional stock of the same class for the plant, but to issue stock of a different class—say preferred stock—another step has been taken. Whereas before the shareholder had an interest in the entire profits, now he has an interest in so much of the profits as remain after deducting the preferred dividend requirements.

The problem, therefore, with which corporation lawyers, business men and courts have been wrestling for years is to grant to the management liberty of action in securing new capital so that they can make their operating power fully effective; but at the same time to restrict this liberty of action so that the holders of outstanding stock or securities do not leave the value of their holdings completely at the mercy of the management.

There is an economic interest in granting to the persons responsible for the operations of the company the fullest discretion in such operations. There is also, however, an interest in maintaining property rights on a stable and equitable basis. Reconciling these two is a fundamental problem.

The foregoing will serve as some guide in analyzing the statutes and certificate of incorporation constituting the corporate contract, and also cases having to do with the nature of the corporate contract. It must be remembered that the science of business organization is not more than forty years old; that neither legislatures, courts, nor business men had clearly in mind the distinction between operations and property interests noted above; and that a consideration of them by courts and lawyers was forced only when corporate structures began to become complex, especially through the invention of preferred stocks. The reasoning of the cases ought therefore to be considered from at least two angles. As a matter of business the decisions ought to be analyzed with a view to seeing whether they achieve a fair balance of the interests above noted. The reasons given by the courts, however, must be analyzed separately, with a view to determining the mechanics by which the courts achieve the results they consider as fair, and, indeed whether they consider that reaching a fair business result has anything to do with their decision.

FREEDOM TO CONTRACT IN CORPORATE CHARTERS

From the statutes it is obvious that, if and as necessary, the state has specifically recorded its permission to the participants in a corporation to make a wide range of contracts.

These permit agreements giving corporate managements, and/or groups of the participants having voting rights, apparently almost unlimited powers in determining property interests; in changing or redetermining interests already defined; in making agreements in the first instance and in altering agreements already made. A study of the Blue Network Company, Inc. charter (and of other charters) indicates the extent to which this permission has been availed of.

It is at present a point of contention between lawyers as to whether the agreement as made is the sole arbiter of the rights of the participants; or whether the law imposes limitations upon the powers, exemptions from liability and other faculties which may be given by the corporate contract to managements and/or groups of participants with respect to the interests of the parties to the corporate contract.

Freedom of contract is the principle insisted on by one school of thought. It is illustrated by the following quotation:

"While it may be conceded that draftsmen of corporate documents sometimes incorporate provisions purporting to grant to the corporation itself, or to the management, powers which so shock the conscience that they should be held to be invalid, and although it may also be conceded that courts of equity should be zealous to protect against, and find remedies for, abuse of powers by corporate managements or by one class of security holders as against another class, nevertheless it is at least questionable whether there is not more loss than gain in the development of rules of law disregarding the clear language of contracts made between competent adults, wholly without any element of coercion, or in the development of rules affecting the obligations of management so rigid in their standards as to make responsible men hesitate to assume the risk of adverse after-the-fact claims by disgruntled—or blackmailing—stockholders. Undoubtedly legal principles are constantly following the development of higher ethical standards, but should they not follow such developments? In other fields of law there is, and always has been, a substantial gap between the strict rules of law, or, indeed, the principles enforced by chancery, and the commonly accepted principles of etiquette and ethics." [Swaine, 38 Yale L.J. 1003, 1004 (1929)].

Equitable control over contracts to safeguard a dominant social interest is the opposite point of view. Protagonists of it point out that the common law has overridden freedom of private contract in numerous cases to reach a desirable result or to safeguard a paramount interest, for instance:

Agreements creating trusts,

Agreements clogging equities of redemption, in mortgages,

Agreements with carriers and public utilities,

Life insurance policies,

Agreements restraining alienation of personal property, and so forth.

To justify this latter position, it must appear (a) that there is a paramount interest in protecting participants' interests; (b) that free contract may reach lengths threatening such interest; (c) that equitable control accomplishes such protection without threatening other greater interests. These are questions of economics, government and sociology rather than law. Students of the subject must therefore consider such questions as (1) the proportion of wealth held by corporations; (2) the number of shareholders; (3) their relative interests in corporate property; (4) the relative desirability of encouraging savings as against rewarding management groups; and cognate problems.

It is not now open to question that to some extent the common law, acting through courts of equity, modifies power granted to corporate managements by the contract (which includes both the charter and statute). Nor do the protagonists of "freedom of contract" deny this. Among the problems to be considered are:

(a) Is this common law control a fundamental and underlying qualification of all corporate contracts; or

(b) Are the instances of presently-existing common law control merely isolated controls over particular devices; and, if so

(c) What other or new devices or situations may be expected to call into being such common law control?

In other words, are the rules subsequently to be examined, instances of a fundamental principle, or are they related rules?

As general reading on these topics, see:

Veblen, Thorstein: "Absentee Ownership."

Dewing, Arthur Stone: "Financial Policy of Corporations."

Sée, Henri: "Modern Capitalism" (Tr. by H. B. Vanderblue and Georges F. Doriot.)

Following is a modern (Delaware) certificate of incorporation.

CERTIFICATE OF INCORPORATION OF BLUE NETWORK COMPANY, INC.

ARTICLE I.

The name of the corporation is BLUE NETWORK COMPANY, INC. (hereinafter called "the Company").

ARTICLE II.

The principal office of the Company in the State of Delaware is located at No. 100 West Tenth Street, in the City of Wilmington, County of New Castle. The name and address of its resident agent in charge thereof are The Corporation Trust Company, No. 100 West Tenth Street, Wilmington, Delaware.

ARTICLE III.

The nature of the business and the objects or purposes for which, and for any of which, the Company is formed and its business is to be transacted, promoted or carried on are to do any or all of the things herein set forth to the same extent that a natural person might or could do, viz:

1. To engage in the business of radio broadcasting and radio network broadcasting, and to do all things incidental thereto; and

2. Without limitation of the generality of the provisions of paragraph 1 of this Article III,

(a) To broadcast, disseminate, distribute, transmit, retransmit, receive or collect, by means of electricity, magnetism or electromagnetic waves, variations or impulses, or otherwise, music, instruction, entertainment, news, speeches, sermons, advertising, educational and informative matter, photographs, pictures, scenes, plays, light, heat, and energy in any form, for the purpose of entertainment, instruction or information or to be so utilized by the persons receiving the same; and to provide and furnish for the use of others, facilities for any of such purposes;

(b) To originate, arrange, provide, buy, sell, and distribute, with or without compensation, programs consisting of or containing the matters or things enumerated in the preceding sub-paragraph, for broadcasting, dissemination or distribution, by means of electricity, magnetism or electromagnetic waves, variations or impulses, or otherwise; and to contract with and engage the services of artists and others for the purpose of providing such programs;

(c) To buy, hire, construct, establish, maintain and operate stations, studios, plants, wires, underground or other circuits and any

and all machinery and apparatus incidental or necessary to the conduct of any of the purposes herein stated;

(d) To lease, sublease, or license others to use the lines, systems or circuits, stations, studios and any other facilities of the Company to persons, firms, associations or corporations, public or private, for compensation or otherwise, for such period of time and under such conditions as the Company may determine;

(e) To generate, produce, control, furnish, sell or otherwise utilize in any manner whatsoever, and for any and every purpose, electricity, magnetism and electromagnetic, radio and every other kind of waves, power, energy or force, variations and impulses; to create, install and operate systems or circuits of communication which may be intrastate, interstate or international; to engage in research and experimental work in and to develop and prosecute the art and business of electric communication, including each and every type of radio communication;

(f) To compose, print, publish, distribute, sell or otherwise dispose of programs, music, plays, magazines, books, pamphlets and other literature, and to acquire, hold, use, sell or in any manner dispose of, or deal with, copyrights or other rights connected with the same;

(g) To carry on advertising campaigns for the promotion of the good will of the public toward the Company's customers and to carry on a general advertising business;

(h) To apply for, obtain, register, purchase, lease or otherwise acquire, and to hold, own, use, develop, operate and introduce, and to sell, assign, grant licenses or rights in respect of, or otherwise to turn to account or dispose of, copyrights, trade marks, trade names, brands, labels, patent rights, letters patent of the United States or of any other country or government, inventions, improvements and processes, whether used in connection with or secured under letters patent or otherwise;

(i) To manufacture, purchase or otherwise acquire, own, mortgage, pledge, sell, assign and transfer, or otherwise dispose of, to invest, trade, and deal in, goods, wares, merchandise and personal property of every class and description;

(j) To acquire, and pay for in cash, stock or bonds of the Company or otherwise, the good will, rights, assets and property, and to undertake or assume the whole or any part of the obligations or liabilities, of any person, firm, association or corporation;

(k) To guarantee, purchase, hold, sell, assign, transfer, mortgage, pledge or otherwise dispose of shares of the capital stock of, or any bonds, securities or evidences of indebtedness issued by, any other corporation organized under the laws of any State or nation, and while the owner thereof to exercise all the rights, powers and privileges of ownership;

(l) To aid in any manner any corporation whose stocks, bonds, or other obligations are held or guaranteed by the Company or in which the Company is otherwise interested, and to do any other act or thing to preserve, protect, improve or enhance the value of any such stocks, bonds or other obligations.

(m) To enter into, make and perform contracts of every kind and description with any person, firm, association, corporation, municipality, county, State, or nation, territory, dependency or colony thereof;

(n) To borrow money and to draw, make, accept, endorse, execute and issue promissory notes, drafts, bills of exchange, warrants, bonds, debentures and other negotiable or non-negotiable instruments and evidences of indebtedness, and to secure the payment of any such securities and of the interest thereon by mortgage upon or pledge, conveyance or assignment in trust of the whole or any part of the property of the Company, whether at the time owned or thereafter to be acquired, and to sell, pledge or otherwise dispose of such bonds or other obligations of the Company;

(o) To have one or more offices, to carry on all or any of its operations, and, without restriction or limit as to amount, to purchase or otherwise acquire, hold, own, mortgage, sell, convey, or otherwise dispose of real and personal property of every class and description, in each State, District, territory, or possession of the United States, and in each foreign country and colony thereof; and

(p) To carry on any other business in connection with the foregoing, and to have and exercise all the powers conferred by the laws of Delaware upon a corporation formed under the General Corporation Law of the State of Delaware.

The provisions of this Article III shall be construed both as objects and powers, and the foregoing enumeration of specific objects and powers shall not be held to limit or restrict in any manner the powers of the Company.

ARTICLE IV.

1. The total number of shares of stock which the Company shall have authority to issue is 1,000 shares, of the par value of $100 per share.
2. The minimum amount of capital with which the Company will commence business is $1,000.

ARTICLE V.

The name, place of residence and citizenship of each of the incorporators are as follows:

Name	Residence	Citizenship
Wm. R. Eberle	Mount Vernon, N. Y.	United States of America
Clifton J. Finch	New York, N. Y.	United States of America
Joseph V. Heffernan	New York, N. Y.	United States of America

ARTICLE VI.

The Company is to have perpetual existence.

ARTICLE VII.

The private property of the stockholders shall not be subject to the payment of corporate debts to any extent whatever.

ARTICLE VIII.

1. No person shall be eligible for election as a Director or officer of the Company who is not at the time of his election a citizen of the United States.

2. In furtherance and not in limitation of the powers conferred by statute, the Board of Directors is expressly authorized, subject to the provisions of Article IV hereof:

(a) To make, alter or repeal the By-Laws of the Company;

(b) To authorize and cause to be executed mortgages and liens upon the real and personal property of the Company;

(c) To set apart out of any of the funds of the Company available for dividends a reserve or reserves for any proper purpose and to abolish any such reserve;

(d) To fix and change from time to time the amount to be reserved as working capital over and above the capital stock paid in;

(e) To sell, exchange, assign, convey or otherwise dispose of a part of the property, assets and effects of the Company less than the whole or less than substantially the whole thereof, on such terms and conditions as the Board of Directors shall deem advisable and without the assent of the stockholders in writing or otherwise; and

(f) From time to time to determine whether and to what extent and at what times and places and under what conditions and regulations the accounts and books of the Company (other than the stock ledger) or any of them shall be open to inspection of stockholders; and no stockholder shall have any right to inspect any account, book or document of the Company, except as conferred by statute, unless authorized by resolution of the stockholders or Directors.

3. No holder of any class of stock of the Company shall be entitled, as of right, to subscribe for, purchase or receive any part of any new or additional issue of any class of stock of the Company, or of any issue of notes, bonds, debentures, or other securities convertible into any class of stock of the Company, or of any issue of warrants, options or other rights to subscribe to any class of stock of the Company or to notes, bonds, debentures, or other securities convertible into any class of stock of the Company; and any such issue of stock, notes, bonds, debentures, warrants, options, rights, or other securities may be sold by the Board of Directors, without prior offer to the stockholders for pro rata subscription by them, at such price, to such purchasers, and upon such other terms and conditions as the Board of Directors shall deem advisable.

4. No contract or other transaction between the Company and any other corporation, including an affiliate of the Company, shall be deemed affected or invalidated by reason of the fact that one or more of the Directors of the Company is a director or officer of, or

are directors or officers of, or is or are interested in, such other corporation. Any Director or Directors of the Company, individually or jointly, may be a party or parties to, or may be interested in, any contract or transaction with the Company, or in which the Company is also interested; and no contract, act or transaction of the Company with any person, firm, association or corporation shall be deemed affected or invalidated by the fact that any Director or Directors of the Company is a party to, or are parties to, or interested in, such contract, act or transaction, if the fact that such Director or Directors was or were interested was disclosed to or known by the Board of Directors or a majority thereof at the time the contract was entered into or the act or transaction took place.

5. Each Director and officer of the Company shall be indemnified by the Company against expenses reasonably incurred by him in connection with any action, suit or proceeding to which he may be made a party by reason of his being or having been a Director or officer of the Company, except in relation to matters as to which he shall be finally adjudged in such action, suit or proceeding to have been derelict in the performance of his duty as such Director or officer. Such right of indemnification shall not be deemed exclusive of any other rights to which he may be entitled as a matter of law.

6. The Company reserves the right to amend, alter, change or repeal any provision contained in this Certificate of Incorporation in the manner now or hereafter prescribed by law, and all rights conferred upon stockholders herein are granted subject to this reservation.

We, the Undersigned, being each of the incorporators named in Article V of the foregoing Certificate of Incorporation, in order to form a corporation in accordance with the provisions of the General Corporation Law of the State of Delaware, do make this certificate, hereby declaring and certifying that the facts herein set forth are true.

In Witness Whereof we have hereunto set our hands and seals on January 9, 1942.

Wm. R. Eberle [Seal]
Clifton J. Finch [Seal]
Joseph V. Heffernan [Seal]

In presence of:
Virginia McCutcheon
as to all

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss:

Be it Remembered, That on this 9th day of January, A.D. 1942, personally came before me Ella Stonebraker, a Notary Public for the State of New York, Wm. R. Eberle, Clifton J. Finch and Joseph v. Heffernan, all of the parties to the foregoing Certificate of Incorporation, known to me personally to be such, and severally acknowl-

edge the said Certificate to be the act and deed of the signers respectively and that the facts therein stated are truly set forth.

Given under my hand and seal of office the day and year aforesaid.

Ella Stonebraker
Notary Public

Notary Public, New York County,
Clerk's No. 823, Register's No. 3S1298
Commission Expires March 30, 1943
[Notarial Seal]

NOTE

The certificate of organization papers of a corporation, in form, contemplate three or four incorporators, deciding to enter a business, determining the powers they need and capital they will get together by selling stock, and drawing up the arrangement as a certificate of incorporation.

Once this is filed or accepted by the state, they then hold a meeting; adopt by-laws; elect directors, and so forth, all in regular parliamentary procedure.

But in point of fact, more often than not, one or more businessmen talk matters over with a lawyer, and request that a corporation be formed. Their plans are frequently indefinite at this stage. The lawyer telegraphs the Secretary of State to inquire whether a particular name is available as a corporate name; and on discovering that it is, thereupon sits down and dictates a full set of papers, naming as incorporators three associates in his office. They are called in and invited to sign; the certificate is sent off; and a copy is enclosed which is returned with an official stamp indicating that it has been filed. The three associates thereupon get together (if the work is carefully done) and hold their meeting. If it is carelessly done, they may merely sign the papers where indicated, thus completing a perfect record of a meeting. In either case the process is often casual to the last degree.

Not infrequently the fictitious quality of the proceeding is perpetuated through the first Directors' meeting. When the businessman has not yet decided how he will constitute his Board of Directors, a group of "dummies" are often named—associates in the law office, or in the office of the businessman, who are expected to vote as the lawyer's papers indicate and resigning on request to make way for the definitive members of the Board. Almost every law clerk in a large law office has at one time or another been incorporator, dummy, director, or perhaps even dummy president or secretary of corporations which later appear as very substantial concerns.

There follow the minutes of the organization meetings.

MINUTES OF AN INCORPORATOR'S MEETING (DELAWARE)

(Courtesy of the Corporation Trust Co., New York City)

The meeting of the incorporators of ——— was held on the ——— day of ———, 19—, at —.M., at its principal office, No. 100 West Tenth Street, Wilmington, Delaware, pursuant to a written waiver of notice signed by all said incorporators, fixing said time and place, as follows:

WAIVER OF NOTICE

MEETING OF INCORPORATORS

We, the undersigned, being all the incorporators of ———, incorporated under the laws of the State of Delaware, ———, do hereby waive notice of the time, place and purpose of the first meeting of the said corporation and do fix the ——— day of ——— 19—, at ——— o'clock in the ——— noon, as the time, and the principal office of said corporation, No. 100 West Tenth Street, Wilmington, Delaware, as the place of said meeting.

And we do hereby waive all the requirements of the statutes of Delaware, both as to the notice of this meeting and the publication thereof; and we do consent to the transaction of such business as may come before said meeting.

Dated, ———, 19—.

The following incorporators were present in person:

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being all of the incorporators.

NOTE.—If stock is subscribed for in certificate of incorporation change foregoing to show number of shares subscribed for.

Upon motion, Mr. ——— was chosen as chairman, and Mr. ——— was chosen as secretary of the meeting.

The chairman reported that the certificate of incorporation was filed in the office of the Secretary of State of Delaware, on the ——— day of ———, 19—, and that a certified copy thereof was recorded on the ——— day of ——— 19—, in the office of the Recorder of New Castle County, Delaware, and the secretary was instructed to cause a copy of such certificate of incorporation to be inserted in the minute book.

The secretary presented a form of by-laws for the regulation of the affairs of the corporation, which was read, section by section.

Upon motion, duly made, seconded and carried, it was

Resolved, That the by-laws submitted at and read to this meeting be, and the same hereby are, adopted as and for the by-laws of this corporation, and that the secretary be, and he hereby is, instructed to cause the same to be inserted in the minute book immediately following the copy of the certificate of incorporation.

The chairman stated that the next business before the meeting was the election of a board of directors.

Messrs. ——— and ——— were appointed inspectors of election and thereupon subscribed and swore to the following oath:

(Name of Corporation)

INSPECTOR'S OATH

STATE OF DELAWARE,
COUNTY OF NEW CASTLE, } ss.:

We, ——— and ———, being sworn upon our respective oaths, do severally promise and swear that we will faithfully, honestly and impartially perform the duties of inspectors of election, and will to the best of our skill and ability conduct the election to be held this day for directors of the above named corporation, and make a true report of the same.

Subscribed and sworn to
before me this ———
day of ——— 19—.

Inspectors.

Messrs. ———

were nominated for directors of the corporation, to hold office for the ensuing year and until their respective successors are elected. No other nominations having been made, the polls were duly opened, and all the incorporators having voted by ballot, the chairman declared the polls closed. Thereupon the inspectors canvassed the vote cast and made and presented the following certificate showing the result of the election:

INSPECTORS' CERTIFICATE

We, the Subscribers, Inspectors of Election appointed to act at the meeting of the incorporators of ——— held this ——— day of ———, 19—, do report that, having taken an oath impartially to conduct the election for directors, we did receive the votes of the incorporators by ballot.

We report that ——— votes were cast for the election of directors and that the following persons received the number of votes set opposite their respective names, to wit:

For Directors	Number of Votes

Respectfully submitted,

Inspectors.

The chairman thereupon declared Messrs. ——————————
——————————————————————————
duly elected directors of the corporation to hold office for the ensuing year and until their respective successors are elected.

Upon motion, duly made, seconded and carried, it was

Resolved, That the board of directors be and it hereby is authorized, in its discretion, to issue the shares of the capital stock of this corporation to the full amount or number of shares authorized by the certificate of incorporation, in such amounts and for such considerations as from time to time shall be determined by the board and as may be permitted by law.

Upon motion, duly made, seconded and carried, the meeting thereupon adjourned.

——————————
Secretary of the meeting.

BY-LAWS

(**NOTE:** These by-laws may be altered to suit particular circumstances but the Delaware statutes should be considered in connection with any proposed change.)

OFFICES

1. The principal office shall be in the City of Wilmington, County of New Castle, State of Delaware, and the name of the resident agent in charge thereof is The Corporation Trust Company.

2. The corporation may also have an office in the City of ———, State of ———, and also offices at such other places as the board of directors may from time to time determine or the business of the corporation may require.

STOCKHOLDERS' MEETINGS

3. *All meetings of the stockholders for the election of directors shall be held at the office of the corporation in ———. Meetings of stockholders for any other purpose may be held at such place and time as shall be stated in the notice of the meeting, or in a duly executed waiver of notice thereof.

* NOTE.—A definite time and place should be fixed for the holding of annual meeting of stockholders.

4. *An annual meeting of stockholders, commencing with the year 19—, shall be held on the ——— of ——— in each year if not a legal holiday, and if a legal holiday, then on the next secular day following, at ——— o'clock —.M., at which they shall elect by a plurality vote, by ballot,† a board of directors, and transact such other business as may properly be brought before the meeting.

5. Written notice of the annual meeting shall be served upon or mailed to each stockholder entitled to vote thereat at such address as appears on the books of the corporation, at least ——— days prior to the meeting.

6. At least ten days before every election of directors, a complete list of the stockholders entitled to vote at said election, arranged in alphabetical order, with the residence of each and the number of voting shares held by each, shall be prepared by the secretary. Such list shall be open at the place where the election is to be held for said ten days, to the examination of any stockholder, and shall be produced and kept at the time and place of election during the whole time thereof, and subject to the inspection of any stockholder who may be present.

7. Special meetings of the stockholders, for any purpose or purposes, unless otherwise prescribed by statute or by the certificate of incorporation, may be called by the president and shall be called by the president or secretary at the request in writing of a majority of the board of directors, or at the request in writing of stockholders owning a majority in amount of the entire capital stock of the corporation issued and outstanding and entitled to vote. Such request shall state the purpose or purposes of the proposed meeting.

8. Written notice of a special meeting of stockholders, stating the time and place and object thereof, shall be served upon or mailed to each stockholder entitled to vote thereat at such address as appears on the books of the corporation, at least ——— days before such meeting.

9. Business transacted at all special meetings shall be confined to the objects stated in the call.

10. The holders of a ——— of the stock issued and outstanding and entitled to vote thereat, present in person or represented by proxy, shall be requisite and shall constitute a quorum at all meetings of the stockholders for the transaction of business except as otherwise provided by statute, by the certificate of incorporation or by these by-laws. If, however, such quorum shall not be present or represented at any meeting of the stockholders, the stockholders entitled to vote thereat, present in person or represented by proxy, shall have power to adjourn the meeting from time to time, without notice other than announcement at the meeting, until a quorum shall be present or represented. At such adjourned meeting at which a quorum shall

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* NOTE.—A definite time and place should be fixed for the holding of annual meeting of stockholders.

† NOTE.—If charter provides that directors need not be elected by ballot this requirement may be eliminated.

be present or represented any business may be transacted which might have been transacted at the meeting as originally notified.

11. When a quorum is present at any meeting, the vote of the holders of a majority of the stock having voting power present in person or represented by proxy shall decide any question brought before such meeting, unless the question is one upon which by express provision of the statutes or of the certificate of incorporation or of these by-laws, a different vote is required in which case such express provision shall govern and control the decision of such question.

12. At any meeting of the stockholders every stockholder having the right to vote shall be entitled to vote in person, or by proxy appointed by an instrument in writing subscribed by such stockholder and bearing a date not more than three years prior to said meeting, unless said instrument provides for a longer period. Each stockholder shall have one vote for each share of stock having voting power, registered in his name on the books of the corporation,* and except where the transfer books of the corporation shall have been closed or a date shall have been fixed as a record date for the determination of its stockholders entitled to vote, no share of stock shall be voted on at any election of directors which shall have been transferred on the books of the corporation within twenty days next preceding such election of directors.

13. Whenever the vote of stockholders at a meeting thereof is required or permitted to be taken in connection with any corporate action by any provisions of the statutes or of the certificate of incorporation or of these by-laws, the meeting and vote of stockholders may be dispensed with, if all the stockholders who would have been entitled to vote upon the action if such meeting were held, shall consent in writing to such corporate action being taken.

DIRECTORS

14. The number of directors which shall constitute the whole board shall be ———.† The directors shall be elected at the annual meeting of the stockholders, and each director shall be elected to serve until his successor shall be elected and shall qualify. Directors need not be stockholders.

15. The directors may hold their meetings and keep the books of the corporation, except the original or duplicate stock ledger, outside of Delaware, at the office of the corporation in the City of ———, State of ———, or at such other places as they may from time to time determine.

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* NOTE.—This provision should be changed if the certificate of incorporation provides for cumulative voting.

† NOTE.—In case provision is to be made for an indefinite number of directors this sentence may be replaced by the following: "The number of directors which shall constitute the whole board shall be not less than three nor more than ———. The first board shall consist of ——— directors. Thereafter, within the limits above specified, the number of directors shall be determined by the stockholders at the annual meeting."

16. If the office of any director or directors becomes vacant by reason of death, resignation, retirement, disqualification, removal from office, or otherwise, a majority of the remaining directors, though less than a quorum, shall choose a successor or successors, who shall hold office for the unexpired term in respect to which such vacancy occurred or until the next election of directors.

17. The property and business of the corporation shall be managed by its board of directors which may exercise all such powers of the corporation and do all such lawful acts and things as are not by statute or by the certificate of incorporation or by these by-laws directed or required to be exercised or done by the stockholders.

COMMITTEES OF DIRECTORS

18. The board of directors may, by resolution or resolutions passed by a majority of the whole board, designate one or more committees, each committee to consist of two or more of the directors of the corporation, which, to the extent provided in said resolution or resolutions, shall have and may exercise the powers of the board of directors in the management of the business and affairs of the corporation, and may have power to authorize the seal of the corporation to be affixed to all papers which may require it. Such committee or committees shall have such name or names as may be determined from time to time by resolution adopted by the board of directors.

19. The committees shall keep regular minutes of their proceedings and report the same to the board when required.

COMPENSATION OF DIRECTORS

20. Directors, as such, shall not receive any stated salary for their services, but, by resolution of the board a fixed sum and expenses of attendance, if any, may be allowed for attendance at each regular or special meeting of the board; provided that nothing herein contained shall be construed to preclude any director from serving the corporation in any other capacity and receiving compensation therefor.

21. Members of special or standing committees may be allowed like compensation for attending committee meetings.

MEETINGS OF THE BOARD

22. The first meeting of each newly elected board shall be held at such time and place either within or without the State of Delaware as shall be fixed by the vote of the stockholders at the annual meeting and no notice of such meeting shall be necessary to the newly elected directors in order legally to constitute the meeting provided a quorum shall be present, or they may meet at such place and time as shall be fixed by the consent in writing of all the directors.

23. Regular meetings of the board may be held without notice at such time and place either within or without the State of Delaware as shall from time to time be determined by the board.

24. Special meetings of the board may be called by the president on ——— days' notice to each director, either personally or by mail or by telegram; special meetings shall be called by the president or secretary in like manner and on like notice on the written request of two directors.

25. At all meetings of the board ——— *directors shall be necessary and sufficient to constitute a quorum for the transaction of business and the act of a majority of the directors present at any meeting at which there is a quorum shall be the act of the board of directors, except as may be otherwise specifically provided by statute or by the certificate of incorporation or by these by-laws. If a quorum shall not be present at any meeting of directors the directors present thereat may adjourn the meeting from time to time, without notice other than announcement at the meeting, until a quorum shall be present.

NOTICES

26. Whenever under the provisions of the statutes or of the certificate of incorporation or of these by-laws, notice is required to be given to any director or stockholder, it shall not be construed to mean personal notice, but such notice may be given in writing, by mail, by depositing the same in a post office or letter box, in a postpaid sealed wrapper, addressed to such director or stockholder at such address as appears on the books of the corporation, or, in default of other address, to such director or stockholder at the General Post Office in the City of Wilmington, Delaware, and such notice shall be deemed to be given at the time when the same shall be thus mailed.

27. Whenever any notice is required to be given under the provisions of the statutes or of the certificate of incorporation, or of these by-laws, a waiver thereof in writing signed by the person or persons entitled to said notice, whether before or after the time stated therein, shall be deemed equivalent thereto.

OFFICERS

28. The officers of the corporation shall be chosen by the directors and shall be a president, a vice-president, a secretary and a treasurer. The board of directors may also choose additional vice-presidents, and one or more assistant secretaries and assistant treasurers. Two or more offices may be held by the same person, except that where the offices of president and secretary are held by the same person, such person shall not hold any other office.

29. The board of directors at its first meeting after each annual meeting of stockholders shall choose a president from its members,

* NOTE.—The by-laws may provide that any number of directors, but not less than one-third of the total number of the board nor less than two, shall be a quorum.

and one or more vice-presidents, a secretary and a treasurer, none of whom need be a member of the board.

30. The board may appoint such other officers and agents as it shall deem necessary, who shall hold their offices for such terms and shall exercise such powers and perform such duties as shall be determined from time to time by the board.

31. The salaries of all officers and agents of the corporation shall be fixed by the board of directors.

32. The officers of the corporation shall hold office until their successors are chosen and qualify in their stead. Any officer elected or appointed by the board of directors may be removed at any time by the affirmative vote of a majority of the whole board of directors. If the office of any officer becomes vacant for any reason, the vacancy shall be filled by the board of directors.

THE PRESIDENT

33. The president shall be the chief executive officer of the corporation; he shall preside at all meetings of the stockholders and directors, shall be ex officio a member of all standing committees, shall have general and active management of the business of the corporation, and shall see that all orders and resolutions of the board are carried into effect.

34. He shall execute bonds, mortgages and other contracts requiring a seal, under the seal of the corporation, except where required or permitted by law to be otherwise signed and executed and except where the signing and execution thereof shall be expressly delegated by the board of directors to some other officer or agent of the corporation.

VICE-PRESIDENTS

35. The vice-presidents in the order of their seniority shall, in the absence or disability of the president, perform the duties and exercise the powers of the president, and shall perform such other duties as the board of directors shall prescribe.

THE SECRETARY AND ASSISTANT SECRETARIES

36. The secretary shall attend all sessions of the board and all meetings of the stockholders and record all votes and the minutes of all proceedings in a book to be kept for that purpose and shall perform like duties for the standing committees when required. He shall give, or cause to be given, notice of all meetings of the stockholders and special meetings of the board of directors, and shall perform such other duties as may be prescribed by the board of directors or president, under whose supervision he shall be. He shall keep in safe custody the seal of the corporation and, when authorized by the board, affix the same to any instrument requiring it and, when so affixed, it shall be attested by his signature or by the signature of the treasurer or an assistant secretary.

37. The assistant secretaries in order of their seniority shall, in the absence or disability of the secretary, perform the duties and exercise the powers of the secretary and shall perform such other duties as the board of directors shall prescribe.

THE TREASURER AND ASSISTANT TREASURERS

38. The treasurer shall have the custody of the corporate funds and securities and shall keep full and accurate accounts of receipts and disbursements in books belonging to the corporation and shall deposit all moneys and other valuable effects in the name and to the credit of the corporation in such depositories as may be designated by the board of directors.

39. He shall disburse the funds of the corporation as may be ordered by the board, taking proper vouchers for such disbursements, and shall render to the president and directors, at the regular meetings of the board, or whenever they may require it, an account of all his transactions as treasurer and of the financial condition of the corporation.

40. If required by the board of directors, he shall give the corporation a bond (which shall be renewed every six years) in such sum and with such surety or sureties as shall be satisfactory to the board for the faithful performance of the duties of his office and for the restoration to the corporation, in case of his death, resignation, retirement or removal from office, of all books, papers, vouchers, money and other property of whatever kind in his possession or under his control belonging to the corporation.

41. The assistant treasurers in the order of their seniority shall, in the absence or disability of the treasurer, perform the duties and exercise the powers of the treasurer and shall perform such other duties as the board of directors shall prescribe.

CERTIFICATES OF STOCK

42. The certificates of stock of the corporation shall be numbered and shall be entered in the books of the corporation as they are issued. They shall exhibit the holder's name and number of shares and shall be signed by the president or a vice-president and the treasurer or an assistant treasurer or the secretary or an assistant secretary.* If any stock certificate is signed (1) by a transfer agent or an assistant transfer agent or (2) by a transfer clerk acting on behalf of the corporation and a registrar, the signature of any such officer may be facsimile.

* NOTE.—If the corporation has more than one class of stock or more than one series of any class add: The designations, preferences and relative, participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights shall be set forth in full or summarized on the face or back of the certificates which the corporation shall issue to represent such class or series of stock.

The following may be added if desired: Certificates may be issued for partly paid shares and in such case upon the face or back of the certificates issued to represent any such partly paid shares, the total amount of the consideration to be paid therefor, and the amount paid thereon shall be specified.

TRANSFERS OF STOCK

43. Upon surrender to the corporation or the transfer agent of the corporation of a certificate for shares duly endorsed or accompanied by proper evidence of succession, assignment or authority to transfer, it shall be the duty of the corporation to issue a new certificate to the person entitled thereto, cancel the old certificate and record the transaction upon its books.

CLOSING OF TRANSFER BOOKS

44. The board of directors shall have power to close the stock transfer books of the corporation for a period not exceeding fifty days preceding the date of any meeting of stockholders or the date for payment of any dividend or the date for the allotment of rights or the date when any change or conversion or exchange of capital stock shall go into effect or for a period of not exceeding fifty days in connection with obtaining the consent of stockholders for any purpose; provided, however, that in lieu of closing the stock transfer books as aforesaid, the board of directors may fix in advance a date, not exceeding fifty days preceding the date of any meeting of stockholders, or the date for the payment of any dividend, or the date for the allotment of rights, or the date when any change or conversion or exchange of capital stock shall go into effect, or a date in connection with obtaining such consent, as a record date for the determination of the stockholders entitled to notice of, and to vote at, any such meeting, and any adjournment thereof, or entitled to receive payment of any such dividend, or to any such allotment of rights, or to exercise the rights in respect of any such change, conversion or exchange of capital stock, or to give such consent, and in such case such stockholders and only such stockholders as shall be stockholders of record on the date so fixed shall be entitled to such notice of, and to vote at, such meeting and any adjournment thereof, or to receive payment of such dividend, or to receive such allotment of rights, or to exercise such rights, or to give such consent, as the case may be, notwithstanding any transfer of any stock on the books of the corporation after any such record date fixed as aforesaid.*

REGISTERED STOCKHOLDERS

45. The corporation shall be entitled to treat the holder of record of any share or shares of stock as the holder in fact thereof and, accordingly, shall not be bound to recognize any equitable or other claim to or interest in such share or shares on the part of any other person, whether or not it shall have express or other notice thereof, except as otherwise provided by the laws of Delaware.

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* NOTE.—An optional provision may be used by which the by-laws may fix a record date for the determination of the stockholders entitled to notice of, etc.

LOST CERTIFICATE

46. The board of directors may direct a new certificate or certificates to be issued in place of any certificate or certificates theretofore issued by the corporation alleged to have been lost or destroyed, upon the making of an affidavit of that fact by the person claiming the certificate of stock to be lost or destroyed. When authorizing such issue of a new certificate or certificates, the board of directors may, in its discretion and as a condition precedent to the issuance thereof, require the owner of such lost or destroyed certificate or certificates, or his legal representative, to advertise the same in such manner as it shall require and/or give the corporation a bond in such sum as it may direct as indemnity against any claim that may be made against the corporation with respect to the certificate alleged to have been lost or destroyed.

DIVIDENDS

47. Dividends upon the capital stock of the corporation, subject to the provisions of the certificate of incorporation, if any, may be declared by the board of directors at any regular or special meeting, pursuant to law. Dividends may be paid in cash, in property, or in shares of the capital stock, subject to the provisions of the certificate of incorporation.

48. Before payment of any dividend, there may be set aside out of any funds of the corporation available for dividends such sum or sums as the directors from time to time, in their absolute discretion, think proper as a reserve fund to meet contingencies, or for equalizing dividends, or for repairing or maintaining any property of the corporation, or for such other purpose as the directors shall think conducive to the interest of the corporation, and the directors may modify or abolish any such reserve in the manner in which it was created.

DIRECTORS' ANNUAL STATEMENT

49. The board of directors shall present at each annual meeting and when called for by vote of the stockholders at any special meeting of the stockholders, a full and clear statement of the business and condition of the corporation.

CHECKS

50. All checks or demands for money and notes of the corporation shall be signed by such officer or officers or such other person or persons as the board of directors may from time to time designate.

FISCAL YEAR

51. The fiscal year shall begin the first day of ——— in each year.

SEAL

52. The corporate seal shall have inscribed thereon the name of the corporation, the year of its organization and the words "Corporate Seal, Delaware". Said seal may be used by causing it or a facsimile thereof to be impressed or affixed or reproduced or otherwise.

AMENDMENTS

53. These by-laws may be altered or repealed at any regular meeting of the stockholders or at any special meeting of the stockholders at which a quorum is present or represented, provided notice of the proposed alteration or repeal be contained in the notice of such special meeting, by the affirmative vote of a majority of the stock entitled to vote at such meeting and present or represented thereat, or by the affirmative vote of a majority of the board of directors at any regular meeting of the board or at any special meeting of the board if notice of the proposed alteration or repeal be contained in the notice of such special meeting; provided, however, that no change of the time or place of the meeting for the election of directors shall be made within sixty days next before the day on which such meeting is to be held, and that in case of any change of such time or place, notice thereof shall be given to each stockholder in person or by letter mailed to his last known post office address at least twenty days before the meeting is held.

MINUTES OF FIRST MEETING OF BOARD OF DIRECTORS

The first meeting of the board of directors of ——— was held at ——— on the ——— day of ———, 19—, at —. M.

Present: Messrs: ————————————————————————————————

———————————————————————————————————————

constituting ——— of the board.

Mr. ——— was chosen temporary chairman and Mr. ——— was chosen temporary secretary of the meeting.

The secretary presented and read the following waiver of notice of the meeting, signed by all the directors:

WAIVER OF NOTICE

FIRST MEETING OF THE BOARD OF DIRECTORS

We, the undersigned, being all the directors of ———, do hereby waive notice of the time, place and purpose of the first meeting of the board of directors of said corporation.

We designate the ——— day of ———, 19—, at ——— o'clock in the ——— noon, as the time, and ——— as the place of said meeting, the purpose thereof being to elect officers, authorize the issue of the capital stock, complete the organization of said corporation, and to transact such other business as may be necessary or advisable.

Dated, ———, 19—.

The minutes of the meeting of incorporators were read and approved.

The following persons were nominated for officers of the corporation to serve until their respective successors are chosen and qualify:

President.

Vice-President.

Secretary.

Treasurer.

All the directors present having voted, the chairman announced that the aforesaid persons had been unanimously elected to the offices set before their respective names.

The president and the secretary thereupon entered upon the discharge of their duties.

(If it is desired that the treasurer give a bond, insert here necessary provision therefor.)

Upon motion, duly made, seconded and carried, it was

RESOLVED, That there shall be an Executive Committee of ——— members of the board of directors which shall have authority to exercise all the powers of the board in the current business of the corporation while the board is not in session.

FURTHER RESOLVED, That Messrs. ——— be and they are hereby designated as members of the Executive Committee (Mr. ——— to be chairman thereof).

Upon motion, duly made, seconded and carried, it was

RESOLVED, That the form of stock certificate presented and read be approved and adopted, and that the secretary be instructed to insert a specimen thereof in the minute book.

Upon motion, duly made, seconded and carried, it was

RESOLVED, That the seal, an impression of which is herewith affixed, be adopted as the corporate seal of the corporation.

The secretary was authorized and directed to procure the proper corporate books.

Upon motion, duly made, seconded and carried, it was

† RESOLVED, That the treasurer be and he is hereby authorized to open a bank account in behalf of the corporation with the ——— Bank of ———.

FURTHER RESOLVED, That until otherwise ordered, said bank be and hereby is authorized to make payments from the funds of

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† Specific bank resolutions may be substituted in lieu of these resolutions.

this corporation on deposit with it upon and according to the check of this corporation signed by ———.

Upon motion, duly made, seconded and carried, it was

RESOLVED, That The Corporation Trust Company as the resident agent of this corporation, in charge of the principal office in Delaware and of the books required by law to be kept in that office, and as the agent upon whom process against this corporation may be served shall act under the direction and supervision of counsel for this corporation in all matters arising out of or pertaining to such agency, including the forwarding of process served, official notices and communications, and all service bulletins covering report and tax requirements, and the secretary is hereby authorized to sign a certificate in accordance with this resolution.

Upon motion, duly made, seconded and carried, it was

RESOLVED, That an office of the corporation be established and maintained at ———, in the City of ———, State of ———, and that meetings of the board of directors from time to time may be held either at the principal office in Wilmington, Delaware, or at such office in the City of ——— or elsewhere, as the board of directors shall from time to time order.

FURTHER RESOLVED, That, until otherwise ordered, regular meetings of the board of directors be held at said office in the City of ———, on the ——— day of each month at —. M.

[Use the following when stock has par value.]

[CASH]

The president stated that he had received subscriptions to ——— shares of the capital stock of this corporation at ——— Dollars ($———) per share.

The treasurer thereupon stated that he had received the sum of ——— Dollars ($———) in full payment at par for the stock subscribed.

Upon motion, duly made, seconded and carried, the president and the ——— were authorized to issue to the said subscribers full paid and non-assessable stock of this corporation to the amount of their respective subscriptions.

[PROPERTY]

The president stated that an offer had been made to the corporation to transfer to it certain property in return for the issuance of stock. Said offer, of which the following is a copy, was presented and read to the meeting:

To ——— Company:

I hereby offer to transfer to ——— Company complete title in fact and of record free from lien or incumbrance, to the following described real (or personal) property, to wit: ————————————

————————————————————————————————

in exchange for ——— shares of the ——— stock, the total value at par of which is ——— Dollars ($———).

If this offer is accepted, the above mentioned ——— shares of the capital stock are to be issued to my order upon the delivery to

your company of the proper instruments of transfer and conveyance of the above mentioned property.

Dated at ———, 19—.

————————. (Seal).

Upon motion, duly made, seconded and carried, the following preambles and resolutions were adopted:

Whereas, ——— has offered to transfer to this corporation in full payment for ——— shares of the capital stock of this corporation, to be issued to him or his nominees, property as follows: ———

---

and

Whereas, In the judgment of this board said property is necessary for the business of this corporation and is of a value at least equal to the par value of the stock demanded therefor;

Now, therefore, be it

RESOLVED, That the offer of said ——— to transfer to this corporation the property hereinbefore described, which said property the board of directors does hereby adjudge and declare to be the value of at least ——— Dollars ($———), and necessary for the business of this corporation, be and it is hereby accepted and that the ——— and ——— of this corporation be and they hereby are authorized and directed to execute and deliver, in the name and on behalf of this corporation and under its corporate seal, such agreement or agreements as may be necessary for the purchase of said property in accordance with said offer and that the officers of this corporation be and they hereby are further authorized and directed to issue to the order of said ———, or his nominees, certificates of full paid and non-assessable stock of this corporation for the shares provided to be issued by the foregoing resolutions upon transfer of said property to this corporation.

The president stated the foregoing {payment of cash / transfer of property} constituted a payment of at least the amount of capital stated in the certificate of incorporation as the amount of capital with which this corporation would commence business.

NOTE.—Consider necessity of qualifying in state where property is located before sale.

[Use the following when stock without par value is issued.]

[CASH]

Upon motion, duly made, seconded and carried, it was

RESOLVED, That ——— Dollars ($———) per share be fixed as the amount of consideration to be received by this corporation for ——— shares of ——— stock without par value.

The president thereupon stated that he had received subscriptions to ——— shares of the ——— stock of this corporation without par value at ——— Dollars ($———) per share.

The treasurer thereupon stated that he had received the sum of ——— Dollars ($———) in full payment for the foregoing shares without par value and, upon motion, duly made, seconded and carried, the officers of the corporation were authorized to issue to said

subscribers full paid and non-assessable stock to the amount of their respective subscriptions.

Upon motion, duly made, seconded and carried, it was

RESOLVED, That the sum of ——— Dollars ($———) received in payment for the foregoing shares be declared part of the capital of this corporation.

[PROPERTY]

The president stated that an offer had been made to the corporation to transfer to it certain property in return for the issuance of stock. Said offer, of which the following is a copy, was presented and read to the meeting:

To ——— Company:

I hereby offer to transfer to ——— Company complete title in fact and of record free from lien or incumbrance, to the following described real (or personal) property, to wit: ———————————

in exchange for ——— shares of the stock of no par value of said corporation.

If this offer is accepted, the above mentioned shares of the capital stock are to be issued to my order upon the delivery to your Company of the proper instruments of transfer and conveyance of the above mentioned property.

Dated at ———, 19—.

———————. (Seal).

Upon motion, duly made, seconded and carried, the following preambles and resolutions were adopted:

Whereas, ——— has offered to transfer to this corporation in consideration of the issuance to him or his nominees of ——— (———) shares of stock of this corporation without par value, the following described property: ———————————

and

Whereas, In the judgment of this board of directors such property is necessary for the business of this corporation and a proper consideration for the issue of the shares of stock of this corporation without par value;

Now, therefore, be it

RESOLVED, That this corporation accept the offer of said ——— to transfer the above described property, which said property the board of directors hereby declares to be necessary for the business of this corporation and a proper consideration for the issue of ——— (———) shares of stock without par value.

FURTHER RESOLVED, That the officers of this corporation be and they hereby are authorized and directed to execute in the name and on behalf of this corporation and under its corporate seal such agreement or agreements as may be necessary for the acquisition of said property in accordance with said offer and that the officers of this corporation be and they hereby are authorized to issue to the said ——— or his nominees certificates of full paid and non-assessable stock of this corporation for the shares provided to be is-

sued by the foregoing resolutions upon transfer of said property to this corporation.

Upon motion, duly made, seconded and carried, it was

RESOLVED, That the consideration received for the foregoing shares of stock without par value be declared part of the capital of this corporation, and the board of directors does hereby adjudge and declare the said property to be of the value of at least ——— Dollars ($———) for the purpose of determining the Federal Tax on the original issue of this stock and for all other purposes where a valuation must be given or set forth.

The president stated the foregoing {payment of cash / transfer of property} constituted a payment of at least the amount of capital stated in the certificate of incorporation as the amount of capital with which this corporation would commence business.

Upon motion, duly made, seconded and carried, it was

RESOLVED, That for the purpose of authorizing the corporation to do business in any state, territory or dependency of the United States or any foreign country in which it is necessary or expedient for this corporation to transact business, the proper officers of this corporation are hereby authorized to appoint and substitute all necessary agents or attorneys for service of process, to designate and change the location of all necessary statutory offices and, under the corporate seal, to make and file all necessary certificates, reports, powers of attorney and other instruments as may be required by the laws of such state, territory, dependency or country to authorize the corporation to transact business therein and whenever it is expedient for the corporation to cease doing business therein and withdraw therefrom, to revoke any appointment of agent or attorney for service of process, and to file such certificates, reports, revocation of appointment, or surrender of authority as may be necessary to terminate the authority of the corporation to do business in any such state, territory, dependency or country.

Upon motion, duly made, seconded and carried, it was

RESOLVED, That the treasurer be and he hereby is authorized to pay all fees and expenses incident to and necessary for the organization of the corporation.

Upon motion, duly made, seconded and carried, the meeting thereupon adjourned.

———————,
Secretary.

4. CORPORATE POWERS

NEW YORK GENERAL CORPORATION LAW

(EMPOWERING PROVISIONS)

§ 13. *Limitation of powers; provisions of certificates of incorporation.* 1. A corporation shall not possess or exercise any powers unless given by law, or necessary to the powers so given.

2. The certificate of incorporation of a corporation may contain any provision for the regulation of its business and the conduct of its affairs, and any limitation upon its powers, or upon the rights of its stockholders or upon the powers of its directors and members, which does not exempt them from the performance of any obligation or duty imposed by law.

§ 14. *Grant of general powers.* Every corporation as such has power, though not specified in the law under which it is incorporated:

1. To have succession for the period specified in its certificate of incorporation or by statute, and perpetually when no period is specified.

2. To have a common seal, and to alter the same at pleasure. The presence of the seal of a corporation on a written instrument purporting to be executed by authority of the corporation shall constitute a rebuttable presumption that the instrument was so executed.

3. To acquire property for the corporate purposes by grant, gift, purchase, devise or bequest, and to hold and to dispose of the same, subject to such limitations as may be prescribed by law.

4. To appoint such officers and agents as its business shall require, and to fix their compensation, and

5. To make by-laws, not inconsistent with law, for the management of its business, the regulation of its affairs, the transfer of its stock, if it has any, and the calling of meetings of its members. Such by-laws may also fix the amount of stock, in the case of stock corporations, or the number of members, in the case of non-stock corporations, which must be represented at meetings of the stockholders or members to constitute a quorum, unless otherwise provided by law. By-laws duly adopted at a meeting of the members of the corporation shall control the action of its directors except as therein otherwise provided. * * *

(C) DELAWARE GENERAL CORPORATION LAW

(EMPOWERING PROVISIONS)

Sec. 2. *Powers:*—Every corporation created under the provisions of this Chapter shall have power:

1. To have succession, by its corporate name, for the time stated in its Certificate of Incorporation, and when no period is limited, it shall be perpetual.

2. To sue and be sued, complain and defend in any court of law or equity.

3. To have a corporate seal, which may be altered at pleasure, and to use the same by causing it or a facsimile thereof to be impressed or affixed or reproduced or otherwise.

4. To hold, purchase and convey real and personal estate, and to mortgage or lease any such real and personal estate with its franchises; the power to hold real and personal estate, except in the case of religious corporations, shall include the power to take the same by devise or bequest.

5. To appoint such officers and agents as the business of the corporation shall require and to allow them suitable compensation.

6. To make by-laws not inconsistent with the Constitution or laws of the United States or of this State, fixing and altering the number of its directors for the management of its property, the regulation and government of its affairs and for the certification and transfer of its stock with penalties for the breach thereof not exceeding twenty dollars.

7. To wind up and dissolve itself or to be wound up and dissolved in the manner hereinafter mentioned.

8. To conduct business in this State, other States, the District of Columbia, the territories and colonies of the United States and in foreign countries, and have one or more offices out of this State, and to hold, purchase, mortgage and convey real and personal property both within and without this State.

9. To co-operate with other corporations and with natural persons in the creation and maintenance of community funds or of charitable, philanthropic, benevolent or patriotic instrumentalities conducive to public welfare, and its directors or trustees may appropriate and expend for those purposes such sum or sums as they deem expedient and as in their judgment will benefit or contribute to the protection of the corporate interests.

10. To indemnify any and all of its directors or officers or former directors or officers or any person who may have served at its request as a director or officer of another corporation in which it owns shares of capital stock or of which it is a creditor against expenses actually and necessarily incurred by them in connection with the defense of any action, suit or proceeding in which they, or any of them, are made parties, or a party, by reason of being or having been directors or officers or a director or officer of the corporation, or of such other corporation, except in relation to matters as to which any such director or officer or former director or officer or person shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of duty. Such indemnification shall not be deemed exclusive of any other rights to which those indemnified may be entitled, under any by-law, agreement, vote of stockholders, or otherwise.

Sec. 3. *Additional Powers:*—In addition to the powers enumerated in the second section of this Chapter, every corporation, its officers, directors and stockholders, shall possess and exercise all the powers and privileges contained in this Chapter, and the powers expressly given in its charter or in its certificate under which it was incorporated, so far as the same are necessary or convenient to the attainment of the objects set forth in such charter or certificate of incorporation; and shall be governed by the provisions and be subject to the restrictions and liabilities in this Chapter contained, so far as the same are appropriate to and not inconsistent with such charter or Act under which such corporation was formed; and no corporation shall possess or exercise any other corporate powers, except such incidental powers as shall be necessary to the exercise of the power so given. * * *

NOTE

THE DOCTRINE OF "ULTRA VIRES"

The doctrine of corporate existence assumed that a corporation was a fictitious person, created by the state. Such powers as it had proceeded from state grant. If the corporation assumed to act outside the range of powers granted to it by the state, a nice legal question was at once raised. Could such acts have any legal results at all? The phrase "ultra vires" (beyond its power) was applied to action in this field. A vast literature of texts and judicial information was built up around this question. As will be seen, the subject is of far less practical importance today.

A confusion in the use of the phrase ought to be noted. "Ultra vires" applied to the acts of a corporation is accurately used where the corporation has acted in a field in which it is not empowered to act by its charter, or by applicable statute. The question would be raised, for instance, if a corporation organized under an old, special charter with power to own and operate a knitting mill, thereupon engaged in running a tavern; or where a corporation which by its charter was empowered to hold real estate to the value of $100,000 and not more undertook to purchase and hold real estate beyond that limitation.

A second, but fundamentally improper use of the phrase, has crept into the newer cases. Certain acts or policies are forbidden by law or inhibited by settled public policy. For instance, most laws forbid an ordinary business corporation to engage in banking operations—these being reserved to specialized types of corporations, supervised or regulated by the State or Federal government. Individuals as well as corporations may not enter this field without special authorization. Yet it is commonly said, where a corporation wrongfully enters such a field, that the action is *ultra vires*,—meaning not that it is beyond its power, but that it is doing something forbidden to it.

Still a third and likewise unjustified use of the phrase is involved where the corporation has full power to do the act in question, but to do it must proceed in a prescribed manner. For instance, a corporation may have power to increase its capital stock upon authorizing vote by the Board of Directors and appropriate vote by the shareholders at a meeting called for the purpose. If, as occurred in one case, the increase of stock was authorized by a minority of the Board of Directors, the resulting stock issue is sometimes loosely said to have been "ultra vires"—but the term is plainly misused.

Again, the phrase is sometimes used to cover action by a corporate officer who has engaged in transactions outside the scope of his authority; and it is occasionally said that such a transaction is "ultra vires" the officer—which is accurate enough but applies to a quite different situation.

This note deals only with the body of doctrine built up under the first group mentioned.

Early corporations did have grant of limited powers only. The limitations were dictated by a definite public policy. The state definitely feared that corporations would grow to anti-social size; or would, by engaging in many activities, monopolize economic life. Limitation of power was thus a definite and clear-cut attempt to impose social control on the new form of business organization. The conception was that limitation and control could be achieved by making corporate action impossible beyond the field of activity marked out for it by the state.

Present day corporation acts almost completely abandoned this conception. In practice, the "grant of powers" to the corporation consists of approving a corporate charter written by the attorneys for the incorporators; and the charter may include practically any powers and purposes which the incorporators or their counsel agree to write into their documents. Limitations appear by prohibition of entering certain fields; notably banking and public utilities. Naturally,

lawyers who incorporate corporations today draw charters so broad that they permit any conceivable type of activity, aside from those fields specifically prohibited. But even there, the charters commonly include powers covering the subject matter. Thus, an ordinary commercial corporation is commonly authorized by its charter to borrow and loan money. If the corporation then went into the business of borrowing and lending money, it might find itself in the banking business and thus in a prohibited field; though, as a commercial corporation, it would have power to make an occasional loan in connection with its other business. At all events, when a true question of "ultra vires" is raised under a modern charter, it is generally a proof of poor draftsmanship on the part of the incorporating lawyers. The state of Ohio indeed threw overboard the entire doctrine by providing in its incorporation act that corporations should have all the powers of "natural persons" (§ 8623-8, Throckmorton's Ohio Code Annot. 1940) which effectively limits all questions of corporate power; leaving only the problem of ascertaining legal relationships and results where the corporation, exercising its admitted power, has done acts prohibited by law or contrary to settled public policy.

The literature and development of the doctrine of "ultra vires" is thus really the history of the long struggle of businessmen and business corporations against limitations imposed by early plans of social control. The struggle resulted in a substantially complete victory for the businessman and the corporation. The phases of it are interesting as history; may have practical importance where a lawyer finds himself dealing with an ancient charter; and in occasional cases where he is struggling with a badly drafted certificate of incorporation or an unusual set of circumstances.

In Sutton's Hospital Case, 10 Coke 23A, 30B (1613), it was held that a corporation by its mere existence impliedly had certain powers. These were (1) the power of continuing existence irrespective of death or withdrawal of members, (2) of legal existence permitting the corporation to sue and be sued, (3) of having a common seal, and so forth. Practically all corporation acts give these powers to a corporation by direct statutory provision. But Sutton's case introduced the idea: corporate powers could be "implied" as well as explicit; and this offered an intriguing possibility to lawyers seeking to enlarge the scope of activity of corporations acting under limited powers.

Early attacks on the limitation of powers did not deal with the effects of acts outside those powers, but with an endeavor to prove that, despite the expressed limitation, there were added powers "implied" by the limited grant. Enlargement of expressly granted powers in the twilight-zone of implication proceeded merrily. If the thing done could be regarded as reasonably incidental to the corporation's authorized business, there was power to carry on the "understood" as well as the expressed object. Romilly, M. R., in Lyle v. Eastern Bengal Railway, 36 Beav. 10, dealt with a corporation empowered to run a railroad which had also bought a coal mine and was briskly selling coal. The Master of the Rolls thought that the power to run a railroad impliedly included the power to own and operate a colliery, if the chief intent was to secure a cheaper supply of fuel; and if that was its chief intent, the railway could as a side business market coal. The Supreme Court of the United States in 1896 (Jacksonville, Mayport, Pablo Railway & Navigation Company v. Hooper, 160 U.S. 514, 16 S.Ct. 379.) held that a Florida Railroad corporation had power to engage in transactions "incidental or auxiliary" to its main business, and that it might include leasing and operation of resort hotels. To this process there is, of course, no logical end. If the resort business is incidental to a railroad business, the railroad corporation should not find great difficulty in discovering that the food and produce business was incidental in supplying its hotels; and so forth. In Dodge v. Ford Motor Company, 204 Mich. 459, 170 N.W. 668 (1919), the court conceded that building and operating a smelter was "incidental" to the business of manufacturing motor cars, and left open the ques-

tion whether purchase of an iron mine might not likewise be incidental. The tide of such cases came to an end because in the early part of this century legislatures abandoned any real attempt to limit powers and made it easy to resolve views by writing the appropriate charter or by securing an amendment to existing charters.

As a result, when a problem of *ultra vires* is raised, the first recourse of the lawyer is to consider whether the activity or act complained of, though not specifically covered in a grant of power, may not be considered as "implied in" or "incidental or auxiliary to" the actual grant. And indeed, there is powerful logic behind this, though the logic is not that of the lawyer. Business activities are dynamic, and not static. Almost any enterprise in action will develop in unforeseeable directions. The businessman will perceive and follow a related opportunity. The technician will develop new and related processes. The public will demand additional and related services (for instance, that the electric light company shall also service and supply household appliances: Commonwealth of Pennsylvania ex rel. Thomas J. Baldridge v. The Philadelphia Electric Company, 300 Pa. 577, 151 A. 344, affirming 18 Pa. Corp. Rep. 243.). The bicycle garage designing the early motor vehicle insisted on growing into the huge automotive company; the chemical plant found itself carried by its technical staff out of the business of standard chemical supplies and into fields as divergent as plastic appliances and nylon stockings. Social control by limitation of corporate power met and was decisively defeated by the explosive technical and industrial development of the past century.

But there were cases in which, even with the developing doctrine of "implied and incidental" powers, the activity plainly could not be reconciled to the corporate grant. The corporation had in fact assumed to act outside the powers granted to it. Then the legal question was, what were the results of such activities:

(1) Was the corporation bound on a resulting contract or debt?

(2) Was the outsider bound to the corporation?

(3) If the transaction was completed, could either the corporation, the outsider, or a third party challenge or upset the transaction later?

Invariably the atmosphere of these cases was heavily laden against the strict application of the logic of *ultra vires*. Logically, it ought to be said that the corporation having no power in this field could not act at all; that no results could be produced; that the whole transaction was a nullity. Yet the fact was that something had happened: money was paid, goods delivered, agreements entered into, and so forth. The party, be it corporation or outsider, who invoked the doctrine was commonly endeavoring to escape from an obligation or transaction to the results of which, as a matter of ordinary commercial ethics, he ought to be bound. However perfect the logic, he presented no case for sympathy. In consequence we find courts struggling to uphold the transaction without denying its *ultra vires* quality, by building up a series of fictions of "estoppel" which really come to the proposition that courts, conceding the transaction was *ultra vires*, nevertheless deny to one or the other party the right to plead that fact as an element of recovery or defense. Thus an early New York case, Steam Navigation Company v. Weed, 17 Barb. (N.Y.) 378 (1853) held that only the corporation could plead *ultra vires:* it was not available to the other party as a defense. This probably is no longer law.

A second and somewhat later group of cases took the problem in detail. It is often said that the defense of *ultra vires* could not be admitted where the contract had been fully executed on one side: See 14A Corpus Juris 319, 19 C.J.S., Corporations, p. 430; Schlitz Brewing Company v. Missouri Poultry & Game Company, 287 Mo. 400, 229 S.W. 813 (1921).

But even where the contract is not "executed", and, as a companionate doctrine, that where the contract had been fully executed on both sides, no one could challenge the transaction except the state; though the holdings are not consistent.

Clearly there is a different rule which would prevail in either case where the contract or act is merely "beyond the powers" of a corporation, but is prohibited by statute or settled policy.

There is conflict of authority as to whether an *ultra vires* transaction is fully validated by the "stockholders". The general rule is that if all the stockholders have consented, the corporation is bound in the absence of objection by the state: though again this rule is not applied where the transaction is not only beyond the powers, but is actually prohibited.

The doctrine of *ultra vires* thus has been cut down to a point at which it commonly can apply only to fully executory contracts; and even there cases are not wanting in which a contract at least partially executory is upheld: Mutual Life Insurance Company v. Stephens, 214 N.Y. 488, 108 N.E. 856 (1915).

A modern corporation does not have limited powers; where it acts *ultra vires*, the usual reason is bad draftsmanship on the part of the lawyer drawing the certificate of incorporation. Where a corporation is prevented from including certain powers (for instance, the power to conduct banking operations) and therefore does not include such powers in its charter, there is involved, usually, not only the fact that the corporation does not have a grant of power to conduct the operation but also a positive prohibition against conducting it contained in some statute or settled policy of the state.

"Ultra vires" was the result of an attempt to limit the corporation as a matter of social policy. It failed: corporations today are substantially unlimited. There remains merely the occasional case which may occur in a lawyer's practice. A student should know that the problem exists, and the outlines of the huge body of case material dealing with it, so that he can deal with the unusual case should it arise. But *ultra vires*, once the principal preoccupation of corporation lawyers, is today confined to the occasional anachronism which one finds where an ancient corporate charter has been carried forward from an earlier year.

Problems arising out of lack of corporate power because the state has prohibited action are, of course, not unusual. But the rules are far more likely to be those applying to contracts contrary to public policy than rules merely relating to the lack of corporate power.

The decisions which follow indicate the chief areas in which the doctrine of *ultra vires* is still important.

BRINSON v. MILL SUPPLY CO., INC.

Supreme Court of North Carolina, 1941. 219 N.C. 498, 14 S.E.2d 505.

Appeal from Superior Court, Craven County.

Affirmed.

Civil action instituted by W. T. Brinson in behalf of himself and all the stockholders and creditors of The Mill Supply Company against The Mill Supply Company, alleging insolvency and seeking the appointment of a receiver and the liquidation of the corporation.

When the original action came on to be heard on the motion for the appointment of a receiver, E. F. Smallwood was appointed receiver and placed in charge of the assets of the defendant corporation to the end that the corporation might be liquidated and the assets applied to the payment of creditors.

The claimant, Laura H. Harvey, executrix of the last will and testament of Harriet L. Hyman, filed claim with the receiver in the amount of $2,318.97, representing the balance due on a note in the sum of $5,000, executed by Albert F. Patterson, who was, at the

time of the execution thereof, president of the defendant company. The facts in respect thereto are as follows:

On March 14, 1931, Albert F. Patterson borrowed from Harriet L. Hyman the sum of $5,000, evidenced by his note which, under the terms thereof, was payable in stipulated monthly instalments. Fifty shares of the capital stock of The Mill Supply Company was deposited with the payee as collateral security and the note contained the stipulation "that upon payment of the sum of $1,000 on the principal of this note that $1,000 of the par value of said stock shall be released to the maker of this note and upon payment of each subsequent $1,000 a like amount of collateral shall be released to the maker.

"The payment of this note is guaranteed by The Mill Supply Company in accordance with a separate contract of guaranty of even date herewith executed by The Mill Supply Company."

On April 2, 1931, A. F. Patterson, president, and the secretary of the defendant corporation, executed, in the name of the corporation, a contract of guaranty of said note, which contract of guaranty was executed pursuant to a resolution duly adopted by the executive committee, March 14, 1931. This contract contains a similar stipulation to the effect that upon the payment of $1,000 upon the principal of the note, $1,000 par value of the stock deposited as collateral is to be released to A. F. Patterson, the maker.

The executive committee in adopting the resolution authorizing the execution of the contract of guaranty acted by virtue of a resolution of the board of directors vesting it, during the interim between meetings of the board, "with the same power and authority as is vested in the Board of Directors and by any act of said committee taken between the meetings of the Board of Directors shall be as equally binding on the company as though said action had been taken by the Board of Directors".

The receiver denied the claim and the claimant appealed to the Superior Court. Upon hearing in the Superior Court the judge found the facts and concluded that the contract of guaranty was ultra vires. It thereupon adjudged that the claimant recover nothing of the receiver. The claimant excepted and appealed.

BARNHILL, JUSTICE. Was the act of the officers of the defendant corporation, in authorizing and executing the contract of guaranty, ultra vires as contended by the receiver? The court below so concluded. In this conclusion we concur.

For a contract executed by the officer of a corporation to be binding on the corporation it must appear that (1) it was incidental to the business of the corporation; or (2) it was expressly authorized; and (3) it was properly executed.

The charter of the defendant corporation vests it with general authority to acquire, own, mortgage, sell and otherwise deal in real estate, chattels and chattels real without limit as to amount; to deal in mortgages, notes, shares of capital stock and other securities; to acquire the good will, rights, property and assets of all kinds and to undertake the whole or any part of the liabilities of any person, firm, association or corporation, and to pay for the same in cash,

stock, bonds, debentures, notes or other securities of this corporation, or otherwise; to purchase or acquire its own capital stock from time to time to such an extent and in such manner and upon such terms as its board of directors shall determine; to borrow or raise money for any purpose of its incorporation, and to issue its bonds, notes or other obligations for money so borrowed, or in payment of or in exchange for, any real or personal property or rights of franchises acquired or other value received by the corporation and to secure such obligations by pledge or mortgage; and "to do all and everything necessary, suitable, convenient or proper for the accomplishment of any of the purposes, or the attainment of any one or more of the objects herein enumerated, or incident to the power herein named, or which shall at any time appear conducive or expedient for the protection or benefit of the corporation, either as holders of or interest in, any property, or otherwise; with all the powers now or hereafter conferred by the laws of North Carolina upon corporations." There are other powers granted which are in nowise pertinent to the question here presented.

The powers thus granted do not expressly authorize the corporation to issue accommodation paper or to guarantee the obligations of a third party.

It is true that in a letter addressed to the payee of the note the treasurer of the defendant corporation recited the conditions of the note, including the provision in respect to the surrender of the collateral, and says in the letter that such stock "shall be released and turned over to The Mill Supply Company, free and discharged of the lien of said note." But this letter was merely one of transmittal. It constitutes no part of the contract. The guaranty enclosed, as well as the note, which together form the contract, provides that such stock, on compliance with the condition, is to be surrendered to the maker A. F. Patterson. Furthermore, there is no evidence tending to show that any of the stock was ever delivered to the corporation. Hence the contract was not a method adopted for the purchase by the defendant of its own stock as authorized by its charter. Claimant's contention in that respect cannot be sustained.

The provision in the charter authorizing the corporation "to undertake the whole or any part of the liabilities of any person, firm, association or corporation and to pay for the same in cash, stock, bonds, debentures, notes or other securities of this corporation or otherwise" is in connection with, related to and a part of the power granted "to acquire the good will, rights, property and assets of all kinds of any other person", etc. The power granted is the power to assume the liabilities of such firm or corporation whose rights, property and assets are acquired by the corporation. This provision may not be construed to mean that the corporation was vested with power to issue accommodation paper or to become guarantor upon the obligation of a third party.

The contract of guaranty was no part of a transaction in which the corporation was borrowing or raising money for the purposes of

its incorporation. It was clearly and exclusively an act in aid and for the accommodation of its president as an individual. From it the corporation received no benefit.

Hence, it appears that the undertaking of the corporation was not directly "necessary, suitable, convenient or proper for the accomplishment of" either of these or of any other purpose authorized by the charter.

Was the contract of guaranty incidental to or in furtherance of the powers expressly granted? If not, it was ultra vires and unenforceable.

A corporation is an artificial being, created by the State, for the attainment of certain defined purposes, and, therefore, vested with certain specific powers and others fairly and reasonably to be inferred or implied from the express powers and the object of the creation. Acts falling without that boundary are unwarranted—ultra vires. * * *

Ordinarily, the power to endorse or guarantee the payment of negotiable instruments for the benefit of a third party is not within the implied powers conferred upon a private business corporation.

The general rule is that no corporation has the power, by any form of contract or endorsement, to become a guarantor or surety or otherwise lend its credit to another person or corporation. 19 C.J.S., Corporations, p. 917, § 1230, and numerous authorities cited in note 14; 7 Fletcher on Corps. 647; 7 R.C.L. 675.

In the absence of express statutory authorization, a corporation has no implied power to lend its credit to another by issuing or endorsing bills or notes for his accommodation, where the transaction is not related to the business activity authorized by its charter as a necessary or usual incident thereto. 14A C.J. 732, sec. 2781, 19 C.J.S., Corporations, p. 914, § 1228.

A corporation is without implied power to guarantee for accommodation the contract of its customers with third persons on the ground that it may thus stimulate its own business. Such use of its credit is clearly beyond the power of an ordinary business corporation. Bowman Lumber Co. v. Pierson, 110 Tex. 543, 221 S.W. 930, 11 A.L.R. 547; North Side R. Co. v. Worthington, 88 Tex. 562, 30 S.W. 1055, 53 Am.St.Rep. 778. It has no authority to use its credit for the benefit of a stockholder or officer. Hunter v. Garanflo, 246 Mo. 131, 151 S.W. 741; First Sav. & T. Co. v. Romadka, 7 Cir., 216 F. 113, 132 C.C.A. 357.

A claim of the holder of promissory notes made by an officer of a corporation against the corporation as accommodation endorser thereon, which endorsement was authorized by the stockholders, is not provable against the corporation in subsequent bankruptcy proceedings, In re Amdur Shoe Co., D.C., 13 F.2d 147.

Trustees of Charlotte Tp. v. Piedmont Realty Co., 134 N.C. 41, 46 S.E. 723, and other cases to the same effect, holding that where the contract is executed by the other party to the contract and the corporation has received the benefit thereof it is estopped from setting up the defense that it was ultra vires, are not in point.

The question here presented is not whether there was sufficient consideration to support the note. The question is, Was there sufficient consideration moving to the corporation to support the contract of guaranty? The liability of the individual upon the note (which was not signed by the corporation) is not contested. It is the liability of the corporation which is at issue. Hence, the rule that where the corporation has received the benefits under a contract which is not incidental, it will be held liable under the doctrine of estoppel, for the reason that it should not be permitted to accept and retain the benefits and at the same time disavow the contract on the plea of ultra vires, has no application. It is when the corporation has received the full benefit of the contract that it will not be relieved of liability because the contract was ultra vires. Farmers Atlantic Bank v. First Nat. Bank, 198 N.C. 477, 152 S.E. 403; Indiana Quarries Co. v. Angier Bank & Trust Co., 190 N.C. 277, 129 S.E. 619. See also Cameron County Lumber Co. v. Al & Lloyd Parker, Inc., 122 Tex. 487, 62 S.W.2d 63; Brand v. Eastland County Lumber Co., Tex.Civ.App., 77 S.W.2d 600; 14A C.J. 329 note 16, 19 C.J.S., Corporations, § 977, note 73. This rule does not impose liability upon the corporation when no benefit has accrued to it by reason of its contract—here the contract of guaranty.

"If it shall be found that the notes were executed by the president of defendant corporation, not in pursuance of or as an incident of the corporate business, wholly without consideration or benefit of any kind to the corporation, then such execution and delivery of the notes would be an ultra vires act". Lentz v. Johnson & Sons, Inc., 207 N. C. 614, 178 S.E. 226, 228, and cases cited. Commissioners of Brunswick v. Bank of Southport, 196 N.C. 198, 145 S.E. 227.

The contract of guaranty was executed for the benefit of an individual. No part of the consideration moved to the defendant corporation. It was not either expressly or impliedly authorized by its charter to enter into contracts for the accommodation of a third party. To permit the payment of the claim would clearly result in an invasion of the assets of the defendant corporation in the hands of the receiver as a trust fund for the payment of legitimate creditors. See 7 R.C.L. 198. The defendant's plea of ultra vires must be sustained.

The judgment below is affirmed.

JACKSONVILLE, M. P. RY. & NAV. CO. v. HOOPER et al.

Supreme Court of the United States, 1896. 160 U.S. 514, 16 S.Ct. 379.

In the circuit court of the United States for the Northern district of Florida, on the 4th day of December, 1889, Mary J. Hooper, Henry H. Hooper, her husband, and William F. Porter, for the use of said Mary J. Hooper, citizens of the state of Ohio, brought an action against the Jacksonville, Mayport, Pablo Railway & Navigation Company, a corporation of the state of Florida. The plaintiffs' amended declaration set up causes of action arising out of the covenants contained in a certain indenture of lease between the parties. This lease,

dated July 10, 1888, purported to grant, for a term of two years, certain lots of land situated at a place called "Burnside," in Duval county, Fla., whereon was erected an hotel known as the "San Diego Hotel." In consideration of this grant, the railroad company agreed to pay, in monthly installments, a yearly rent of $800, and to keep the premises insured in the sum of $6,000.

It was alleged that on November 28, 1889, during said term, and while the railway company was in possession, the hotel and other buildings were wholly destroyed by fire; that the defendant had failed and neglected to have the same insured; and that there was an arrearage of rent due amounting to the sum of $106.67. For the amount of the loss occasioned by the absence of insurance, and for the back rent, the action was brought.

The defendant denied that the railway company had duly executed the instrument sued on; denied that Alexander Wallace, the president of the company, and who had executed the lease as such president, had any authority from the company so to do. The defendant also alleged that such a lease, even if formally executed, was ultra vires; also, that the covenant to insure was an impossible covenant, as shown by ineffectual efforts to secure such insurance.

The case was tried in April, 1891, and resulted in a verdict and judgment against the defendant in the sum of $6,798.70. On errors assigned to certain rulings of the court and in the charge to the jury, the case was brought to this court.

MR. JUSTICE SHIRAS, after stating the facts in the foregoing language, delivered the opinion of the court. * * *

It is, however, further claimed that the contract sued on was not within the legitimate powers of the company.

This is not a case in which, either by its charter or by some statute binding upon it, the company is forbidden to make such a contract. Indeed, the public laws of Florida, referring to the powers of railroad companies, provide that every such corporation shall be empowered "to purchase, hold, and use all such real estate and other property as may be necessary for the construction and maintenance of its road and canal and the stations and other accommodations necessary to accomplish the objects of its incorporation, and to sell, lease, or buy any land or real estate not necessary for its use." McClel. Dig. Laws Fla. p. 278, § 10. They are likewise authorized "to erect and maintain all convenient buildings, wharves, docks, stations, fixtures, and machinery for the accommodation and use of their passengers and freight business."

Although the contract power of railroad companies is to be deemed restricted to the general purposes for which they are designed, yet there are many transactions which are incidental or auxiliary to its main business, or which may become useful in the care and management of the property which it is authorized to hold, and in the safety and comfort of the passengers whom it is its duty to transport.

Courts may be permitted, where there is no legislative prohibition shown, to put a favorable construction upon such exercise of power by a railroad company as is suitable to promote the success of the

company, within its chartered powers, and to contribute to the comfort of those who travel thereon. To lease and maintain a summer hotel at the seaside terminus of a railroad might obviously increase the business of the company and the comfort of its passengers, and be within the provisions of the statute of Florida above cited, whereby a railroad company is authorized "to sell, lease, or buy any land or real estate not necessary for its use," and to "erect and maintain all convenient buildings * * * for the accommodation and use of their passengers."

Courts may well be astute in dealing with efforts of corporations to usurp powers not granted them, or to stretch their lawful franchises against the interests of the public. Nor would we be understood to hold that, in a clear case of the exercise of a power forbidden by its charter or contrary to public policy, a railroad company would be estopped to decline to be bound by its own act, even when fulfilled by the other contracting party. Davis v. Railroad Co., 131 Mass. 258; Thomas v. Railroad Co., 101 U.S. 71; Central Transp. Co. v. Pullman's Palace Car Co., 139 U.S. 24, 11 S.Ct. 478. So, too, it must be regarded as well settled, on the soundest principles of public policy, that a contract by which a railroad company seeks to render itself incapable of performing its duties to the public, or attempts to absolve itself from its obligation without the consent of the state, is void, and cannot be rendered enforceable by the doctrines of estoppel. Railroad Co. v. Winans, 17 How. 30; Thomas v. Railroad Co., 101 U.S. 71; Central Transp. Co. v. Pullman Car Co., 139 U.S. 24, 11 S.Ct. 478.

We do not seek to relax, but rather to affirm, the rule laid down by this court, in Central Transp. Co. v. Pullman Car Co. (above cited), that "a contract of a corporation which is ultra vires, in the proper sense,—that is to say, outside the object of its creation, as defined in the law of its organization,—and therefore beyond the powers conferred upon it by the legislature, is not voidable only, but wholly void, and of no legal effect. The objection to the contract is not merely that the corporation ought not to have made it, but that it could not make it. Such a contract cannot be ratified by either party, because it could not have been authorized by either. No performance on either side can give the unlawful contract any validity, or be the foundation of any right of action upon it." 139 U.S. 59, 60, 11 S.Ct. 478.

But we think the present case falls within the language of Lord Chancellor Selborne in Attorney General v. Great Eastern Ry. Co., 5 App.Cas. 478, where, while declaring his sense of the importance of the doctrine of ultra vires, he said: "This doctrine ought to be reasonably, and not unreasonably, understood and applied; and that whatever may fairly be regarded as incidental to, or consequential upon, those things which the legislature has authorized, ought not, unless expressly prohibited, to be held, by judicial construction, to be ultra vires." In the application of the doctrine, the court must be influenced somewhat by the special circumstances of the case. As was said by Romilly, M. R., in Lyde v. Railway Co., 36 Beav. 10,

where was in question the validity of a contract by a railway company to work a coal mine: "The answer to the question appears to me to depend upon the facts of each particular case. If, in truth, the real object of the colliery was to supply the railway with cheaper coals, it would be proper to allow the accidental additional profit of selling coal to others; but, if the principal object of the colliery was to undertake the business of raising and selling coals, then it would be a perversion of the funds of the company, and a scheme which ought not to be permitted, however profitable it might appear to be. The prohibition or permission to carry on this trade would depend on the conclusions which the court drew from the evidence."

The principle upon which we may safely rule the present question is within the case of Brown v. Winnisimmet Co., 11 Allen, 326. There a contract, made by the treasurer of a ferry company, to lease one of the company's boats for a certain money consideration, was alleged to be void for want of antecedent authority given by the company to the treasurer, and also because such a contract was not made in the legitimate exercise of the company's powers. On the first point it was ruled that, from evidence showing ratification by the company, it was proper for the jury to infer that the treasurer had been duly authorized to make the contract, and, disposing of the second question, the court, through Chief Justice Bigelow, said: "We know of no rule or principle by which an act creating a corporation for certain specific objects, or to carry on a particular trade or business, is to be strictly construed as prohibitory of all other dealings or transactions not coming within the exact scope of those designated. Undoubtedly, the main business of a corporation is to be confined to that class of operations which properly appertain to the general purposes for which its charter was granted. But it may also enter into and engage in transactions which are auxiliary or incidental to its main business, which may become necessary, expedient, or profitable in the care and management of the property which it is authorized to hold under the act by which it was created." See, also, Davis v. Railroad Co., 131 Mass. 258, 272.

The contract between the parties hereto was for leasing an hotel at the terminus of the railroad, situated at a beach, distant from any town. If not fairly within the authority granted by the statute of Florida "to erect and maintain all convenient buildings * * * for the accommodation and use of their passengers," it certainly cannot be said to have been forbidden by such laws. Nor can it be said to have been, in its nature, contrary to public policy.

To maintain cheap hotels or eating houses, at stated points, on a long line of railroad through a wilderness, as in the case of the Pacific railroads, or at the end of a railroad on a barren, unsettled beach, as in the present case, not for the purpose of making money out of such business, but to furnish reasonable and necessary accommodations to its passengers and employés, would not be so plainly an act outside of the powers of a railroad company as to compel a court to sustain the defense of ultra vires, as against the other party to such a contract.

But, even if the railroad company might be answerable for the rent of the premises, it is contended that the covenant to procure insurance was so far outside of the company's powers as not to be enforceable.

No one could deny that it would not be competent for a railroad company, without the authority of the legislature, to carry on an insurance business. But this covenant to keep the premises insured is correlative to the obligation of the lessors to rebuild in case the hotel should be destroyed by fire, and to the provision that, in such an event, the rents should cease until the hotel should be put in habitable condition and repair by the lessors. Such mutual covenants are quite usual in leases of this kind, and are merely incidental to the principal purpose of the contract. * * *

* * * The judgment of the court below is affirmed.

COMMONWEALTH OF PENNSYLVANIA ex rel. THOMAS J BALDRIDGE, Attorney General v. THE PHILADELPHIA ELECTRIC COMPANY.

Court of Common Pleas of Pennsylvania, Philadelphia County, 1929. 18 Pa. Corp. Rep. 243; affirmed, 300 Pa. 557, 151 A. 344.

BY THE COURT, June 7, 1929:

This case was tried by the Court without a jury.

It is a quo warranto proceeding, wherein the suggestion is made that the respondent, The Philadelphia Electric Company, has exercised powers and franchises that are not within the corporate grant, or incidental or auxiliary thereto.

A petition was addressed to the Attorney General by the Merchant & Evans Company, averring that the sale by the respondent of certain electrical appliances was not within the latter's corporate powers. The Attorney General permitted the use of the name of the Commonwealth.

Findings of Fact

From the pleadings and the proofs we find the facts to be as follows:

1. The respondent, The Philadelphia Electric Company, is a corporation incorporated under the laws of the Commonwealth of Pennsylvania on October 27, 1902, for the purpose of "supplying light, heat and power by electricity to the public in the city and county of Philadelphia, and to such persons, partnerships and corporations residing therein or adjacent thereto as may desire the same."

2. Electricity is a commodity which can only be used through the medium of some sort of an appliance and before it can be successfully sold prospective customers must necessarily be supplied with appliances which in one form or another consume electricity.

3. During the entire period of its corporate existence it has been the practice of the respondent in common with practically all other electric light, heat and power companies throughout the Commonwealth, to merchandise and sell electrical appliances as a part and

branch of its business incidental to the development of its business generally, and this practice of respondent and others has always been considered to be an important and essential incident to the continued growth and success of respondent's main corporate purpose of supplying electricity to the public.

4. The appliances so merchandised and sold by the respondent include, inter alia, such devices as vacuum cleaners, washing machines, electric refrigerators, curling-irons, heaters, sewing machines, hair dryers, heating pads, bread mixers, percolators, toasters, grills, waffle irons, dish washers, ranges, fans and radios.

5. Respondent added electrical refrigerators to its general line of appliances more than eleven years ago, and until the commencement of the present proceeding the Commonwealth never questioned respondent's corporate right to do so.

6. Respondent has eleven branch offices or places of business in its territory where these appliances are demonstrated and offered for sale in connection with the business of selling electric current at these branch offices.

7. These safe appliances, including specifically electric refrigerators, are also being continually and generally sold throughout the respondent's territory by the manufacturers thereof, as well as by department and other stores in direct competition with respondent.

8. It has been found that the efforts of the respondent in popularizing and demonstrating these appliances has resulted in a considerable benefit to other distributors and dealers in such appliances.

9. The volume of merchandising business thus done by respondent itself amounts to approximately only five per cent of respondent's entire business, and the volume of respondent's business in the sale of electric refrigerators amounts to approximately only one per cent of its said entire business.

10. The primary object of respondent in merchandising electrical appliances is to stimulate in every proper way a demand for the use and consumption of electric current which in turn promotes the respondent's business generally by increasing the sale of such current.

11. An increase in the respondent's sales of electric current is a distinct advantage to the customer because in its final effect such increase produces and makes possible a lower energy cost rate to the customer.

12. One of the duties of respondent, essential to its continued success in business, is to maintain a thoroughly satisfactory service to its customers and the nature of the commodity sold is such that this involves from a practical standpoint the maintenance in good condition of the appliances on its lines.

13. This present action was initiated by the Attorney General only after the filing with him of a petition for the institution of same by Merchant & Evans Company, a private corporation engaged in the business of manufacturing and selling a certain kind of electric refrigerator which is not one of the kinds sold by respondent.

Discussion

The plaintiff correctly states the general propositions of law which govern the case: A Pennsylvania corporation cannot engage in any business except that expressly authorized by its charter, and has no powers except those which are necessary to enable it to carry out an express grant. Penna. R. R. v. Canal Commissions, 21 Pa. 9; Solar Electric Co.'s Appeal, 290 Pa. 156, 138 A. 845; Bangor Electric Co.'s Petition, 295 Pa. 228, 145 A. 128; Article XVI, Section 6, Constitution of Pennsylvania.

This being the conceded rule, the problem we face is the interpretation of the respondent's grant.

This was: That it be incorporated "for the purpose of supplying heat, light and power by electricity to the public."

This grant was made in 1902 and the phrase used was no doubt intended to include, in a general way, all of the conveniences that could be produced by the use of the electric current. The relator's objections do not raise any question arising out of any particular use, but they dispute the right of the respondent to do anything more than supply electric current, and particularly they dispute its right to engage in merchandising the devices needed for converting electricity.

This interpretation, however, runs counter to the express language of the grant, which is not a power to "supply electricity," but certain things produced by electricity. Far from preventing the Company from dealing in the converting devices needed, it would be our inclination to insist that it is part of its duty to furnish them to its customers. It is unimportant whether the converting device is supplied separately, by means of a sale or a bailing and a charge specially made for it, or whether the bill rendered the customer for the service includes also the use of the converting device.

A grant very similar to the one before us was passed upon by the Supreme Court in the case of Malone v. The Lancaster Gas Light Company, in 182 Pa. 309, 37 A. 932. The company in that case, as the name indicates, was a gas company. There is a close analogy between the supply of heat, light and power by electricity and their supply by means of gas. Both gas and electricity are useless until they are converted into some form of activity, and for this in both cases mechanical devices are needed.

In Malone v. The Lancaster Gas Light Company, the grant was "for the purpose of manufacturing and supplying illuminating and heating gas."

Plaintiff's counsel is not correct in his brief in saying that the company in the case cited "was chartered to supply light and heat." The power was to supply gas.

If the Lancaster Company had been chartered to supply light and heat by means of gas, the analogy of the two charters would be complete. Yet, notwithstanding the fact that the express words of the Lancaster grant were only "to supply gas," the Supreme Court held that it "might not only supply gas itself, but may also inci-

dentally deal in such appliances and conveniences as will induce new customers to use gas or old ones to use more." "It is argued for plaintiff," said Mr. Justice Mitchell, "that the charter purpose of the gas company is limited by the words 'manufacturing and supplying illuminating and heating gas,' and that nothing can be included which it (sic) not a necessary part or appliance for manufacturing or supplying. This is too narrow and literal a construction, and overlooks the fundamental object of the corporation, the manufacture and supply of gas to customers for profit. It would be no use to manufacture gas if there were not customers to buy, and hence the company may fairly supply not only the gas itself, but incidentally such appliances as will induce new customers to use gas, and old customers to use more."

It is plain that the instant case is much stronger for the respondent than the case cited, because in the latter the power was to "supply gas," while here it is to supply certain conveniences "by means of electricity." As we have pointed out, this must include the supply of any device that will be needed to turn electricity into the convenience desired.

It is not wandering too far afield to point out, and it appears in the proofs, that in 1902 the industry in which the respondent was and still is engaged, was comparatively new. The public had not been educated with regard to the multitude of conveniences which the electric current will supply. To furnish the housekeeper with the electric current alone would have resulted in neither profit to the company nor convenience to the customer. What the latter wanted, and what the Legislature intended to grant when it authorized the respondent to furnish light, heat and power by electricity, was something more than furnishing the customer with the end of an insulated copper wire, that he did not know how to use, or had not the appliances to use. It was intended that he should have and the company should furnish the conveniences that could be obtained by the use of the electric current.

For these reasons we come to the following

Conclusions of Law

1. The sale by respondent of electrical refrigerators and other electrical appliances is in furtherance of its main corporate purpose of "supplying light, heat and power by electricity to the public," in the territory covered by respondent's charter.

2. A verdict and judgment thereon should be entered in favor of the respondent.

JOSEPH SCHLITZ BREWING COMPANY v. MISSOURI POULTRY & GAME COMPANY et al.

Supreme Court of Missouri, 1921. 287 Mo. 400, 229 S.W. 813.

Action by the Joseph Schlitz Brewing Company against the Missouri Poultry & Game Company and others. From a judgment for plaintiff, defendants and plaintiff both appeal. Affirmed.

JAMES T. BLAIR, J. Plaintiff is a Wisconsin corporation which formerly brewed and sold beer. Defendant Missouri Poultry & Game Company is a Missouri corporation. In August, 1905, F. W. Brockman went to Milwaukee and orally agreed with plaintiff to purchase beer from it; that he would form a corporation for that purpose; that he would go into the business and finance it, furnish a bond signed by himself and August Gehner, and in due time notify plaintiff when to commence shipping its product. On August 26, 1905, the bond was signed. * * *

I. The total amount of beer sold to the Poultry & Game Company was very large. The gross amount billed during one month, which, it seems, is illustrative of the business done, was over $14,000. The net price was over $6,300. The balance sued for probably represents the net due for the last few weeks before the notice of termination was given by plaintiff. It is not contended the sale of beer was illegal at that time nor that it ran counter to the then public policy. It is argued the contract to purchase was ultra vires of the Poultry & Game Company. The charter of that company, as incorporated in 1893, disclosed it was then incorporated to deal in dressed poultry, game, and country produce. The representation as to the formation of a corporation in 1905 seems to have been untrue. The charter does not expressly invalidate transactions outside the charter powers. St. Louis Drug Co. v. Robinson, 81 Mo. loc. cit. 26. The contract has been fully executed by plaintiff. The Poultry & Game Company has received and had full benefit of the shipments of beer represented by the sued for balance.

With respect to estoppel to plead ultra vires to a contract fully executed on one side defendants rely upon the federal rule, in the main. This court and the Courts of Appeals of this state long since adopted the rule in force in most of the states which we said in Millinery Co. v. Trust Co., 251 Mo. loc. cit. 579, 158 S.W. 359, had been tersely stated by Rombauer, P. J., in Winscott v. Inv. Co., 63 Mo.App. loc. cit. 369, to be that:

"The defense of ultra vires is not admissible where the contract has been fully executed on one side, unless it is a contract expressly prohibited by law." * * *

In Anglo-American Land, M. & A. Co. v. Lombard, 132 F. loc. cit. 741 et seq., 68 C.C.A. 89, the United States Circuit Court of Appeals was considering an executory feature of the contract before it when it discussed the rule in this state. The court said:

"Of course, the present question is whether the Missouri company's acquisition of the stock of the Kansas company and the incurrence of the stockholder's liability, which is inseparable from ownership of the stock—a liability which has not been discharged and remains an executory obligation—was void in toto or only voidable; in other words, whether the act of a corporation which is not within the scope of its corporate powers, and is therefore prohibited [citations], can have or be given the effect of placing upon the corporation an enforceable executory obligation." 132 F. loc. cit. 742, 68 C.C.A. 89.

It is clear this was understood in the case of Millinery Co. v. Trust Co., supra, and that the case was not given approval as authority for the broad doctrine it is here contended it announced. In fact, in the Millinery Co. Case the exact contrary was expressly stated to be the rule in this state.

It is argued the provisions of section 9749, R.S.1919, and section 7 of article 12 of the Constitution of the state to the effect that "no corporation shall engage in business other than that expressly authorized in its charter or the law under which it may have been or may hereafter be organized" preclude a holding that defendants are estopped to set up that the contract in this case was ultra vires of the Poultry & Game Company. The provisions quoted were in existence at the time the cited decisions of this court were made, and the doctrine of estoppel has been applied when the constitutional provision mentioned was before the court. Summet v. Realty & Brokerage Co., 208 Mo. loc. cit. 512, 513, 106 S.W. 614. In fact, the violation of some restriction upon the exertion of power by a corporation is the essence of ultra vires action. It would be strange if this court and the Courts of Appeals would so often apply the doctrine of estoppel in the face of the provisions quoted if their effect is to render that doctrine inapplicable in this state. Such is not the case. The question is one often decided. Those provisions but incorporate the applicable common law, which is that corporations are restricted to the powers given by their charters. The exception to the general rule of estoppel made in case a charter or provision of law "expressly" prohibits the making of a contract by a corporation cannot be grounded upon the common law or provisions declaratory of it, as are those quoted. The question under these same Missouri provisions was discussed by the United States Circuit Court of Appeals for this circuit in St. Avit v. Kettle River Co., 216 F. loc. cit. 875, 876, 133 C.C.A. 76, and a conclusion adverse to appellants' present claim was reached. In National Bank v. Matthews, 98 U.S. loc. cit. 629, 25 L. Ed. 190, the record under review was that of this court in Matthews v. Skinker et al., 62 Mo. 329, 21 Am.Rep. 425. In one paragraph of its opinion the Supreme Court of the United States assumed the correctness of the holding of this court that a deed of trust acquired by a national bank by the purchase of the note it secured was thereby brought within section 5137, U.S.R.S.1899 (13 Stat. 99 [Comp.St. § 9674]), which prohibited a national bank from holding "the possession of any real estate under mortgage," but nevertheless held the debtor could not be heard to say the security was unenforceable because ultra vires of the bank. * * * The judgment of this court in that case was reversed. In Michigan a statute provided that the articles of association should state "the purpose or purposes for which the corporation is formed, and it shall not be lawful for said corporation to divert its operations or appropriate its funds to any other purpose, except as hereinafter provided." Pub.Acts 1885, No. 232, § 2. It was held (Butterworth & Lowe v. Milling Co., 115 Mich. loc. cit. 3, 72 N.W. 990) that a transgression of this prohibition might subject the offending corporation to action by the state "or other ap-

propriate proceeding," but did not prevent the application of the doctrine of estoppel to contracts ultra vires of the corporation. In Texas a statute provided:

"No corporation created under the provisions of this title shall employ its stock, means, * * * or other property, directly or indirectly, for any other purpose * * * than to accomplish the legitimate objects of its creation." Rev.St.1879, art. 589.

A corporation organized to manufacture and vend cotton and woolen goods loaned money to one Bond and took his note. When sued, Bond pleaded ultra vires. After approving the general rule that the execution by one party to an ultra vires contract estops the other to plead ultra vires as a defense, the court (Bond v. Mfg. Co., 82 Tex. loc. cit. 313, 18 S.W. 693) dealt with the question of the effect of the quoted statute as follows:

"It is true that a distinction is made between the act of a corporation which is merely without authority and one which is illegal. In the one case, it is a question of authority; in the other, of legality. A corporate act becomes illegal when committed in violation of an express statute on a specific subject, or when it is malum in se or malum prohibitum, or when it is against public policy. Beach on Priv. Corp. § 438; Taylor on Priv. Corp. §§ 293–295. If, therefore, the transaction here engaged in by appellee was * * * beyond its powers, but was also illegal, in the sense stated, the contention of appellants should prevail. It will be noted that article 589, * * * is a general statute. It is merely declaratory of the common law, by which corporations are strictly confined in their powers to the limits and fixed purposes for which they were created. The language of the statute at most emphasizes the doctrine of the common law. To such 'general prohibitions, against the doing by corporations of acts beyond the scope of the corporate powers, courts appear to give little effect.' Taylor on Corp. § 295; Curtis v. Leavitt, 15 N.Y. 54; Halstead v. Mayor, 3 N.Y. 430–433. And in many cases (and these in our opinion the most authoritative) where the statute has a specific, but at the same time an implied, application, the doctrine of estoppel against the beneficiary of an executed contract is not changed."

The court cites National Bank v. Matthews as typical of this last-mentioned class. A like holding was made with respect to a similar statute in Harris v. Gas Co., 76 Kan. loc. cit. 762, 92 P. 1127 (13 L.R.A.,N.S., 1171). The court quoted and approved 1 Clark & Marshall, Priv. Corp. § 225b, to the effect that:

"A provision in a general corporation law that no corporation created thereunder shall employ its assets for any other purpose than to accomplish the legitimate objects of its creation is merely declaratory of the common law, * * * and does not amount to such an express statutory prohibition of ultra vires loans and other transactions as to render them illegal instead of ultra vires merely."

In 2 Morawetz on Corporations, § 558, it is stated that provisions in charters of corporations and in general laws "prohibiting corporations from exercising any powers except those conferred by their

charters" are "merely declaratory of the general common-law prohibition against any exercise of corporate powers which has not been authorized by the Legislature; and there is no reason for supposing that the Legislature intends to give it any greater force or effect than the common-law rule." He points out that statutes of the kind are generally so construed or "ignored" by the courts. In Erb v. Yoerg, 64 Minn. loc. cit. 465, 67 N.W. 355, it was held that one who had sold and delivered goods to a corporation on an ultra vires contract could not replevin them, since the corporation was estopped to plead ultra vires, though a statute made an offense of any "diversion of corporate property to other objects than those specified in the articles." While the quoted constitutional provision would prevent any general legislative authorization contrary to its terms, yet its restrictive effect upon corporations is no greater than its language imports when given its ordinary meaning. Black on Interpretation of Laws (2d Ed.) § 11, p. 25; Sedgwick on Constr. of State & Const. Law (3d Ed.) p. 19. It is argued the decision in Orpheum Theater Co. v. Brokerage Co., 197 Mo.App. 661, 199 S.W. 257, is in conflict with these views. That it contains language apparently justifying such a suggestion cannot be denied. Yet that case involved the enforceability of a voluntary subscription by a brokerage corporation to a theater corporation to aid in building a home for the latter. The court stated the brokerage company had "no interest in the matter which could be subserved" by the erection of the theater building. In other words, as held by the superior court of Kentucky in a like case (L. & N. R. R. v. Literary Society of St. Rose, 11 Ky.Law Rep. 861) the brokerage company received no benefit peculiar to it, and therefore had not received anything from the contract which could render applicable the doctrine of estoppel. In so far as the remainder of the opinion in the case cited is concerned, it is, if not obiter, out of accord with the settled rule in this state. It results that this point is ruled against appellants. * * *

For the reasons given, the judgment is affirmed.

TEXAS COMPANY v. Z. & M. INDEPENDENT OIL COMPANY, Incorporated.

Circuit Court of Appeals of the United States, Second Circuit, 1946. 156 F.2d 862.

Action by the Texas Company against Z. & M. Independent Oil Company, Inc., for specific performance of an option agreement whereby the defendant agreed to sell to the plaintiff the physical properties used by the defendant in its business, wherein the defendant filed a counterclaim. From an adverse judgment, 66 F.Supp. 957, the defendant appeals.

Affirmed.

SWAN, CIRCUIT JUDGE. This litigation concerns an option to purchase granted under date of September 20, 1929, by Z. & M. Independent Oil Company, Inc. (hereafter called Z & M), to The Texas

Company (hereafter called Texas). Texas gave notice on August 29, 1944 that it elected to exercise the option and thereafter brought the present action for specific performance of the resulting contract. Federal jurisdiction rests on diverse citizenship, Texas being a Delaware corporation and Z & M a New York corporation. The case was tried to the court without a jury and judgment was given for the plaintiff, with a reference to a special master to find the present fair value of the properties covered by the option, that is, the price to be paid for them. * * *

Execution of the sales contract and the option agreement was authorized by resolutions of the directors of Z & M on September 18, 1929; and on September 23, 1929 identical resolutions were unanimously adopted at a special meeting of Z & M's stockholders, all of whom were present in person or by proxy.[2] After the making of the sales contract of September 20, 1929, frequent renewals or modifications thereof were effected by the exchange of letters between the parties which changed the seller's prices, established new rates of discount to Z & M, added new products and named new points of shipment and distribution. On December 27, 1941, Z & M notified Texas that it elected to terminate as of June 30, 1942 the sales contract of September 20, 1929, and all renewals or modifications thereof, as well as the option agreement. But as a result of negotiations this attempted cancellation was withdrawn and the sales contract and option agreement were extended to June 30, 1944 and from year to year thereafter, subject to termination by either party by 180 days prior notice, with an express stipulation that Texas should not have the privilege of exercising the option before June 30, 1944, or until the expiration of six months after the cessation of hostilities between the United States and Germany and Japan, but might exercise it "at any time after June 30, 1944, according to the terms and conditions of said option, upon giving 180 days written notice to" Z & M.

In April 1944 all of the stock of Z & M was purchased by the Gulf Oil Corporation. Texas did not learn of this transaction until August 28, 1944. The following day Texas notified Z & M by letter that it exercised the option of September 20, 1929 and demanded a statement of the property covered and of the value of each item thereof. Z & M replied denying the existence of any option agreement. The Gulf Oil Corporation, which knew of the sales contract and option agreement before purchasing the Z & M stock, likewise informed Texas that it repudiated the option agreement and did not consent to such a sale. Thereupon Texas brought the action now before us.

Several of the appellant's contentions are based on section 20 of the Stock Corporation Law of New York. This statute permits a corporation to sell and convey all its property with the consent of two-thirds of its stockholders obtained at a meeting called pursuant

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[2] Mr. Zuber owned more than two-thirds of Z & M's stock from January 1, 1929 to December 21, 1941 when he made a gift of 800 shares each to his wife and daughter. At all material times 97% of the stock was owned by members of the Zuber family and Mr. Zuber exercised full control over Z & M's affairs with the acquiescence of each of its shareholders.

to section 45. The appellant argues that the consent of stockholders to the granting of an option is not a consent to a sale or conveyance, and consequently the Z & M stockholders' resolution of September 23, 1929 was "an unnecessary and meaningless act." If this were sound, it would mean that a corporation could never grant a valid option to purchase all its property. No authority is cited which supports this extraordinary interpretation of section 20. An option is an irrevocable offer to sell which becomes a binding contract of sale on acceptance by the optionee. If two-thirds of the stockholders can authorize the officers to enter into a contract of sale, we can conceive of no possible reason why they cannot authorize the making of an irrevocable offer, as well as a revocable offer, of such a contract. In either case the objecting minority may have its stock valued and retired under section 21. See Matter of Goelet, 289 N.Y. 735, 46 N.E. 2d 349; Matter of Thomas, 259 App.Div. 736, 18 N.Y.S.2d 314.

The appellant also contends that the resolution of September 23, 1929 did not authorize the option agreement actually made; and certainly did not authorize the modifications of July 6, 1942. Neither objection is tenable. The statute does not require any particular form of consent; hence the stockholders' resolution need not set out the agreement in extenso. See Greenpoint Sugar Co. v. Whitin, 69 N.Y. 328, 334; Lincoln Sterling Corp. v. State Theatre Dunkirk, 256 App.Div. 1035, 10 N.Y.S.2d 813. It was sufficient that the resolution made plain the stockholders' intention to consent and that the officers acted within the scope of the authority conferred upon them. As to the modifications of July 6, 1942, they put no added burdens on Z & M; they merely required Texas to forbear from exercising the option until June 30, 1944 and lengthened the notice to be given of election to exercise it. Conceivably any extension of the option might be thought a new irrevocable offer requiring a new consent by the stockholders, but we think not in view of the provision that the original option might be exercised during the term of the sales contract of September 20, 1929 "or any renewal or other agreement in lieu thereof." But regardless of that, by the law of New York, if the contract is not positively forbidden for reasons of public policy independent of protection of shareholders (Berkey v. Third Avenue R. Co., 244 N.Y. 84, 91, 92, 155 N.E. 58, 50 A.L.R. 599), shareholders may not complain of any contract of which they have individually approved regardless of the absence of statutory formalities. Kent v. Quicksilver Mining Co., 78 N.Y. 159, 185–187; Sheldon H. B. Co. v. Eickemeyer H. B. M. Co., 90 N.Y. 607; Giles D. M. Co. v. Klauder-Weldon D. M. Co., 233 N.Y. 470, 476, 135 N. E. 854. One of the main reasons for the enactment of section 20 was to protect minority stockholders, Matter of Timmis, 200 N.Y. 177, 93 N.E. 522; Matter of Drosnes, 187 App.Div. 425, 175 N.E. 628; the section was not intended to enable corporations to avoid their contractual obligations. If two-thirds of the stockholders individually consented it was as effective as if they had voted at a formal meeting. In the case at bar more than the necessary number have consented to all that Zuber did on behalf of Z & M; it would be mon-

strous to allow their successors to repudiate their consent by invoking a statute intended merely for their protection. * * *

Affirmed.

B. PRE-INCORPORATORS

NOTE

"PREINCORPORATORS" AND "PROMOTERS"

It has been made sufficiently plain that before the corporation comes into existence, one or more businessmen have worked on a project for which the corporation is to be a vehicle. The work of assembling the various elements of the enterprise may precede the phase of actual incorporation. Broadly speaking, assembly involves two distinct categories of work: the arrangements to secure property, personnel, supplies and so forth, with which the business is to be done; and the work of assembling the capital necessary to start the enterprise. In the following section only the first aspect is considered. The name "preincorporators" as distinct from the older name, "promoters", is due to Professor E. Merrick Dodd of the Harvard Law School.

Preincorporators are, by assumption, persons working together on a project, for which the corporate form is eventually to be planned. They may have a relationship between themselves if they so agree—but not otherwise, and then only in accordance with their understanding.

They may make agreements with outsiders; and the problem then is whether the outsider is bound to them or they to the outsider; whether, when the corporation later comes into existence, the corporation is bound to them or they to the corporation; and whether in the event that the corporation enters liability on preincorporation arrangements, the preincorporators are released.

Clearly in all of these problems, the parties are able to determine, by careful agreement, how the rights and liabilities shall fall. A preincorporator, for instance, can make an agreement with an outsider that the outsider shall deliver goods to the enterprise, and he can put in a clause that as soon as the corporation shall be formed and shall assume the liability, the incorporator shall automatically be released; or he can make an agreement with the outsider by which the outsider agrees to deliver to the corporation, when formed, and that the outsider will look only to the corporation for his pay; or any other arrangement. But businessmen are apt to move rapidly and without spelling out their full intent. The courts not infrequently have the problem of trying to work out, after the fact, from stated circumstances, what the parties really did have in mind—or, possibly, what they would have had in mind if they had thought of it.

These cases stand in a quite different category from the cases of true "promotion" (which by custom is more usually applied to the financial relations entered into by a preincorporator with the corporation or with others) and which is separately discussed in a later section.

(A) New York Stock Corporation Law, § 69: "No corporation shall issue either shares of stock or bonds, except for money, labor done or property actually received for the use and lawful purposes of such corporation * * *"

"The statute requires that stock shall be paid for either by cash or property. Services rendered in bringing a corporation into existence is neither cash nor property. If it were, then the entire capital stock could be thus disposed of, and the only asset which the corporation would have would be its naked existence." Herbert v. Duryea, 34 App.Div. 478, 480, 54 N.Y.S. 311, 1st Dep't., 1898, aff'd without opinion 164 N.Y. 596, 58 N.E. 1088, 1900.

(B) Corporate directors may be held liable to stockholders in an accounting proceeding, for permitting promoters to receive excessive commissions for the sale

of stock. "Neither the stock nor the property of a corporation may be issued or paid out to a promoter for his services in organizing the corporation." Ludlam v. Riverhead Bond and Mortgage Corporation, 244 App.Div. 113, 119, 278 N.Y.S. 487, 2d Dep't., 1935; order modified and aff'd, 248 App.Div. 908, 290 N.Y.S. 648, 2d Dep't., 1936.[1]

(C) "* * * not every banker's or promoter's profit, taken by way of stock, is open to attack. The labor and acumen required to conceive and organize a modern corporation is far greater than the general public realizes; and it is fair and necessary that those who take long risks and expend much time in the negotiation, preliminary financing, estimating, and assembling of diverse and adverse elements, should be adequately rewarded. A genuine service is performed here, both to the public at large and to the incoming shareholders in particular; and it would be a grossly impracticable rule which denied compensation for such services. But it is here contended that the promoter and the banker are not the sole judges of the reasonableness of the compensation." Berle, Compensation of Bankers and Promoters Through Stock Profits, 1929, 42 Harv.L.Rev. 748, 759. See, also, Brockelbank, The Compensation of Promoters, 1934, 13 Ore.L.Rev. 195; Note, 1935, 20 Marq.L.Rev. 95; 1918, 31 Harv.L.Rev. 895.

(D) On occasion, options to purchase stock are given promoters for their services. Possible objections to such options, by stockholders and creditors are discussed, Note 1929, 29 Col.L.Rev. 491. See, also, Brockelbank, The Compensation of Promoters, 1934, 13 Ore.L.Rev. 195, 221–225, and pp. 379 to 381, infra, on stock purchase warrants.

1. THE RELATIONSHIP OF PRE-INCORPORATORS INTER SESE

HASKINS v. RYAN.[2]

Court of Chancery of New Jersey, 1906. 71 N.J.Eq. 575, 64 A. 436.

On demurrer to bill.

STEVENS, V. C. To the bill in this case a general demurrer is pleaded. The bill alleges, in substance, that during the years 1898, 1899, 1900 and 1901 the complainant devoted a large part of his time to the study of industrial conditions connected with the output of pig lead in the United States, and had conceived the plan of uniting the outstanding lead interests, which had not already become a part of the National Lead Company, into one company, and had either procured options thereon or had opened negotiations for their purchase; that in the spring of 1901

"he had crystallized and formulated a complete plan for the combination of the white lead industries in the United States not already in the National Lead Company; that he laid such plan before the defendant, a capitalist; that he sought his cooperation and aid, and himself agreed to contribute, if necessary, as much as $200,000, if the defendant would join him therein, and also contribute enough to carry the enterprise through."

[1] For possible bases of liability of corporate officers who act as promotors of allied or subsidiary corporations, see Berle, Promotors' Stock in Subsidiary Corporations, 1929, 29 Col.L.Rev. 35.

[2] For an illustration and discussion of the promotion of a corporation, see, Note, High Finance in the Twenties: The United Corporation (I), 1937, 37 Col.L.Rev. 785; Dewing, The Financial Policy of Corporations, 4th Ed., 1941, Vol. I, 407–477; Masslich, Financing a New Corporate Enterprise, 1910, 5 Ill.L.Rev. 70.

The bill alleges, further, that defendant, to quote from the bill,

"expressed a willingness to join your orator therein, provided an examination of the plan and papers by the attorneys and experts of said Ryan [the defendant] confirmed the statements of your orator made to him."

The bill then alleges that the complainant submitted the plan to Ryan's attorney, and was subsequently told by him that he had submitted it to Ryan, and had indorsed it "as comprehensive, feasible, and attractive"; that through the efforts of Ryan's agents, options had been obtained upon most, if not all, of the properties upon which the complainant had options, and that on January 20, 1903, the United Lead Company was organized as a corporation under the laws of New Jersey, and under the direction and control of Ryan proceeded to acquire and now owns the interests in nearly all the companies, firms, and individuals named in complainant's plan, and is capitalized with a capital stock of $15,000,000 and has issued bonds for $17,000,000; that in the formation and exploitation of this company the defendant, Ryan, "has made an enormous profit, the amount of which is unknown to complainant," and that a combination substantially as planned by complainant has taken place, or is about to take place, with the result of great profits to said Ryan.

The bill then charges that Ryan's act of availing himself of the information complainant had collected and had only disclosed to Ryan

"upon the agreement and understanding on the part of the said Ryan that he would join your orator in the said scheme and share with him in the profits arising therefrom is contrary to equity."

But I do not understand that by this general charge it is intended to allege any other understanding or agreement than that contained in the stating part of the bill, viz., that Ryan had expressed a willingness to join complainant in his project, provided an examination of it by Ryan's attorneys and experts should confirm complainant's statements. The bill asks for a discovery and account of Ryan's profits and a decree that complainant is entitled to a share of them. Ryan is the sole defendant.

It is perfectly plain that no recovery can be had in this case on the basis of a completed agreement broken by Ryan. The plan, a copy of which is appended to the bill, contemplates the raising of $15,000,000 for the purpose of acquiring the properties of the various concerns, 22 in number, other than that of the National Lead Company. The raising of a fund with which to purchase these properties was of the essence of the plan, but complainant had not bound himself to contribute any definite sum, and Ryan had not bound himself to contribute anything. Even if, without direct averment, we should infer that an examination of the plan and papers had been made by Ryan's experts, and that such examination confirmed complainant's statements to Ryan, nothing more is shown than that Ryan agreed to join in the plan; that is, agreed to enter into a definite and explicit agreement on the subject. But nothing is better settled than that equity will not compel the specific performance of an agreement to make an agreement. Lane v. Calvary Church, 59 N.J.Eq. 413, 45 A. 702 (affirmed on appeal).

An account on the basis of a completed agreement is, therefore, quite out of the question.

As I understand the complainant's argument, he does not rest his case on any such basis. His contention is this: "The plan is my property. The defendant has appropriated it to his own use. I claim an account of the profits arising from its appropriation."

If, in point of fact, the plan has been wrongfully taken or appropriated, the remedy, if any, would appear to be an action on the case for damages; the amount of damages being its fair value. But the plaintiff does not, and in this court could not, demand damages. He asks for a discovery and an account of profits.

The fact that he has not been able to cite any precedent for the claim he makes is not, of itself, conclusive, if he can bring himself within the principle upon which an account is given.

The complainant has, undoubtedly, the right to claim protection in this court for his manuscript. It would seem that, without any reference to whether the plan is or is not open to the objection that it seeks to create a monopoly (Kerr on Inj. p. 186; Oliver v. Oliver, 11 C.B.N.S., 139), he would have the right to restrain its publication or to prevent its use; and, in the case of an author the law does more than protect the manuscript, regarded as a material thing of ink and paper. The combination of words of which it is composed (whether written down or acted, or sung before an audience admitted on payment of a fee) is also protected, and publication is restrained, even if the manuscript be destroyed and an attempt be made to reproduce it from a copy rightfully in the possession of another, or even from memory. The work is protected indefinitely before publication by the common law (Aronson v. Baker, 43 N.J.Eq. 366, 12 A. 177; N. J. State Dental Ass'n v. Denticura Co., 57 N.J.Eq. 594, 41 A. 672; Denticura Co. v. New Jersey State Dental Soc., 58 N.J.Eq. 582, 43 A. 1898), and for a limited time after publication by the statutory law of copyright. The law has never attempted to go beyond this, and to enjoin, for the benefit of the author, after publication, the use of the ideas contained in his work.

In the case of secret processes of manufacturing, the law does, to a certain extent, enjoin the use of ideas. It would, of course, on the same principle on which it affords protection to the unpublished manuscript in the hands of the author, enjoin the publication or exhibition of the paper containing the formula; but it does more. In enjoining the use of the formula, it restrains the wrongdoer from putting the idea formulated to practical account. * * *

I now come to the precise question here involved. It is this: Has the complainant a property right in the scheme or idea to be found in his plan, as contradistinguished from the property right which he has in his manuscript, regarded as a combination of words and figures—a thing of ink and paper?

A right is defined to be that interest which a person actually has in any subject of property, entitling him to hold or convey it at pleasure. But that can hardly be styled "property," over which there is not some sort of dominion. Now, as I have already said, the combination of words and figures contained in complainant's plan be-

longs to him absolutely. Its publication or reproduction or exhibition in any form may be enjoined. But the idea contained in the plan differs from the ideas to which I have already called attention in this important respect: It involves the voluntary action and co-operation of many different men. When I say voluntary action, I mean action not constrained by contract; for the allegation that complainant had "options" is altogether too vague to warrant an inference that they are still subsisting, or that complainant had the means of availing himself of them without the aid of outside capital. Besides, the allegation is, not that he has procured options on all the properties which it was proposed to combine, but that he either had options on them or had "opened negotiations for their purchase." The means of carrying out the plan, of giving effect to the idea, lay, therefore, beyond his control. It was an idea depending for its realization upon the concurring minds of many individuals, each of them unbound by contract and free to act as he chose. Such a project or idea can scarcely be called "property." It lacks that dominium, that capability of being applied by its originator to his own use, which is the essential characteristic of property. It differs fundamentally from the secret process or patented invention which is capable of material embodiment at the will of the inventor alone. It is worthless unless others agree to give it life. It was, as far as complainant was concerned, an idea pure and simple. Now, it has never, in the absence of contract or statute, been held, so far as I am aware, that mere ideas are capable of legal ownership and protection. Says Lord Brougham, in delivering his judgment in Jeffreys v. Boosey, 4 H.L.Cas. 965: " 'Volat irrevocabile verbum,' whether borne on the wings of the wind or the press, and the supposed owner instantly loses all control over it. * * * He has produced the thought and given it utterance, and eo instante it escapes his grasp." * * *

I am therefore of opinion that complainant has no property right in his plan regarded as an idea. Having no property right, he has no right to an account.

But, if a court of equity cannot treat complainant's idea as property, it is also incapable of giving him the remedy of account on another ground. The charge of the bill is that Ryan should account for complainant's share of any profits reaped by him from or in connection with the promotion and exploitation of the United Lead Company. Now, what profits could the defendant reap therefrom? The suggestion is that he might reap the profits of a promoter. A promoter may sometimes get shares, not issued for money or property purchased. Such shares, viewed from a legal standpoint, are not of much value. But he may also get, by contract, fully paid shares. It is presumably of such shares that the complainant desires an account. Now, on what basis could there be an equitable division of such shares? The complainant charges that it was part of his plan personally to contribute up to $200,000, if necessary. He has in fact contributed nothing. The plan contemplated the raising of $15,000,000. Ryan's interest in the company would depend in part upon the extent to which he had himself contributed, and in part upon

other considerations having no relation to complainant. This being so, it would seem to be utterly impossible, on any recognized basis of apportionment, to take from Ryan a part of his shares and give them to complainant. Complainant, no doubt, expected to secure shares, partly in return for the money to be put in by him and for the services to be performed by him, and partly for the prior work done in formulating the scheme. How much his collaborators in the undertaking, had they taken him in, would have allowed him for what he had done, or would do, is altogether conjectural. It would naturally have been a matter of express contract. I am quite unable to see how a court of equity could make him an allowance by way of account of profits, based upon a condition of affairs wholly unanticipated and wholly unprovided for. Manifestly, the only way of compensating him on any rational basis would be to ascertain what his plan was reasonably worth and then to give him damages. This, of course, would presuppose a property right in the plan. Conceding such right, the damages, if recoverable at all, would be recoverable in a court of law in an action on the case, and not in equity.

I think the complainant's bill should be dismissed.[3]

BROWN v. LEACH et al.

Supreme Court of New York, Appellate Division, First Department, 1919. 189 App.Div. 158, 178 N.Y.S. 319.

Appeal by plaintiff, Charles T. Brown, from a judgment of the Supreme Court in favor of defendants, entered upon a decision of the court after a trial at the New York Special Term.

PAGE, J. Richmond Levering & Company, Inc., prior to June 27, 1917, owned all the issued stock of the Island Oil and Transportation Corporation of the par value of $22,500,000. The latter corporation owned or controlled valuable oil properties and a concession for building a pipe line for the transportation of oil from the well to the seacoast for shipment. This well was of great intrinsic value producing from 70,000 to 100,000 barrels of oil a day. The Island Oil and Transportation Corporation did not have the money necessary to properly develop its oil properties, build the pipe line and proper buildings and tanks for the storage of the oil, and also was obligated to make certain payments on the purchase of its property and for concessions held by it. Prior to June 1, 1917, Richmond Levering, the president of Richmond Levering & Company, Inc., called on the plaintiff and explained to him the situation of the company and its need for immediate financial assistance. The plaintiff loaned to Richmond Levering & Company, Inc., the sum of $9,000 and a further sum of $10,000 for the purpose of protecting its properties and rights, and had procured a further sum of $15,000 by indorsing and securing the discount of its note. The plaintiff suggested a

[3] Aff'd without opinion, 75 N.J.Eq. 623, 73 A. 1118, 1909. An amended bill was dismissed for the reasons stated in the principal case, 75 N.J.Eq. 330, 1908.

scheme for financing the Island Oil and Transportation Corporation, and secured from Levering the privilege of financing the corporation. Levering first authorized the plaintiff to secure loans of money for the use of the corporation, and the plaintiff made persistent but futile efforts to obtain the loans from trust companies with which he had business dealings. He then brought the matter to the attention of Arthur B. Leach of the banking firm of A. B. Leach & Co., and made a proposition to him for the financing of the Island Oil and Transportation Corporation. He informed Leach of the properties, rights and securities of the corporation and their value, and later introduced him to Levering, and there was discussed between the three the financing of the corporation. Prior to that time Leach had never heard of the Island Oil and Transportation Corporation or of its properties and securities, and had not met Levering. Plaintiff had suggested to Levering the plan of selling short time obligations of the corporation secured by its debentures, and repaying the loans out of the proceeds of the sale of its stock and bonds. The plaintiff endeavored to interest Leach because his firm was able to finance enterprises in which it was interested, and sell to the public the obligations or securities of corporations of which it approved.

After several interviews the parties arrived at an agreement which was reduced to writing and signed on the 27th day of June, 1917. The agreement is quite lengthy but may be summarized as follows: It was between Richmond Levering & Company, Inc., party of the first part, and A. B. Leach & Co. and the plaintiff, parties of the second part. The parties of the second part agreed to advance to the party of the first part $50,000 upon receipt of a note of the Island Oil and Transportation Corporation for $300,000 in favor of the party of the first part and to be indorsed by it and Richmond Levering individually, payable in sixty days with interest at five per cent., and to be secured by fifty-one per cent. of the stock of the Island Oil and Transportation Corporation and $160,000 face value of the debentures of said corporation. Within thirty days the parties of the second part were to advance the further sum of $250,000, or such part thereof as the directors of such corporation might require. The parties of the second part to have the privilege of sending to Mexico their representatives to investigate and test the oil well and the properties of the Island Oil and Transportation Corporation for the purpose of obtaining a full report of the same. To cover the expense of this investigation and as compensation for the advance of $300,000, $500,000 par value of the stock of the Island Oil and Transportation Corporation was to be delivered with the said note to the parties of the second part and retained by them. Within sixty days the parties of the second part agreed to notify the party of the first part, in writing, whether they elected to exercise the option which was thereby granted to them, to advance to the Island Oil and Transportation Corporation $1,000,000 in such amounts and at such times as the board of directors thereof might require. In that event the Island Oil and Transportation Corporation was to issue notes in such denomination and to such payees as the parties of the second part might designate, all payable three years after their date, with inter-

est at six per cent., aggregating $1,300,000, secured by $2,600,000 face value of the debentures of the said corporation, and thereupon the $300,000 note was to be canceled. In the event that the parties of the second part gave notice that they would not exercise the option, thereafter the $300,000 should become due and payable within sixty days. If, however, the parties of the second part decided to exercise the option, they would be entitled to receive $11,500,000 par value of the stock of the Island Oil and Transportation Corporation.

The plaintiff and Leach agreed to indorse and discount the $300,000 note. Leach was to sell the securities of the corporation and thus secure the money to pay the note and furnish the $1,000,000 called for by the contract. The profits of the transaction were to be divided between them, A. B. Leach & Co. receiving two-thirds and the plaintiff one-third. It was thus contemplated that the corporation could be financed without the furnishing of cash by the Leach firm or the plaintiff in excess of the initial payments made by each of them. Plaintiff experienced difficulty in arranging the discounting of the $300,000 note. Leach proposed that instead of one note for $300,000, there should be two notes, one for $200,000, which he would take and advance the money, and the other for $100,000 which plaintiff could get discounted, Leach agreeing to indorse the note and furnish from the common fund such collateral as might be necessary. Plaintiff thereupon arranged to have the note discounted by a trust company, but when he called upon Leach to indorse the note as he had agreed, Leach declined, but having recently incorporated his copartnership, offered to indorse the note in the name of the corporation. The president of the trust company refused to accept such indorsement, as a corporation would have no power to become an accommodation indorser. Leach thereafter, although refusing to indorse the note, demanded that the plaintiff should advance the $100,000, which plaintiff could not do. In the meantime an expert engineer had been sent to examine the property of the Island Oil and Transportation Corporation in Mexico. To the expense of this examination the plaintiff and A. B. Leach & Co. contributed. On August 14, 1917, Leach received the report of this engineer, which was favorable except that it stated that the cost of the pipe line would be greater than estimated. On the fifteenth of August, Leach had an interview with plaintiff in which he demanded that plaintiff decrease his share of the compensation from thirty-three and one-third to five per cent. Upon plaintiff's refusal of this offer, Leach offered to go on with the enterprise, if plaintiff would accept seven and one-half per cent. as his share. The plaintiff refused and Leach then gave notice that he would not exercise the option to further finance the Island Oil and Transportation Corporation, and immediately thereafter so notified Richmond Levering. Leach wrote plaintiff on August sixteenth informing him that he would not exercise the option and closing with the statement: "It is the understanding that we are each free to take such further steps in the matter as we may elect, without prejudice." Plaintiff in response wrote that it had been brought to his attention that Leach was contemplating dealing with Levering and ignoring his rights in the premises and protested that they were not free to

act separately. Again on the twenty-first of August plaintiff wrote Leach: "The termination of this option, I am advised, will not leave you free to take such further steps in the matter as you may elect. You cannot use the incident of terminating the option to eliminate me from the situation, and then avail yourself of the information, introductions and suggestions I have given you for your sole profit." Leach knew before the end of August that there was a payment of $90,000 due from the Island Oil and Transportation Corporation upon its Mexican properties. Richmond Levering represented to plaintiff that A. B. Leach & Co. was definitely out of the negotiations and that it would be necessary for him to secure money from other parties in order to save the property to the Island Oil and Transportation Corporation. Believing this representation, the plaintiff was induced to release Richmond Levering & Company, Inc., from all obligation to him under the contract between Richmond Levering & Company, Inc., A. B. Leach & Co. and himself. This release was evidenced by a letter dated August 24, 1917. On Sunday, August 26, 1917, Levering made by telephone an appointment to, and did, meet Leach at a golf club on Long Island, then showed him the letter which he had obtained from plaintiff, and made an appointment to meet Leach at his office in New York the next day. Negotiations were then carried on between Levering and Leach on the twenty-seventh and twenty-eighth of August which resulted in a contract dated August 30, 1917, for the financing of the Island Oil and Transportation Corporation on substantially the same lines and for the same compensation as theretofore provided in the contract of June 27, 1917, except that the plaintiff was eliminated therefrom and A. B. Leach & Co. was to receive all the profits of the transaction.

A. B. Leach & Co. became joint adventurers with the plaintiff in the enterprise, and A. B. Leach & Co. could not exclude the plaintiff from the enterprise for the purpose of securing the entire benefit of the profits to itself. A joint adventure is subject to the same rules as a technical partnership. Where the partnership has for its object the completion of a specified piece of work, or the effecting of a specified result, it will be presumed that the parties intended the relation to continue until the object has been accomplished. Until that time arrives one partner cannot terminate the partnership and continue the enterprise for his own benefit, nor can one partner exclude the other without his consent. It may be terminated at any time by consent, but the consent must be mutual. Hardin v. Robinson, 178 App.Div. 724, 729, 162 N.Y.S. 531, affirmed 223 N.Y. 651, 119 N. E. 1047. When A. B. Leach notified the plaintiff that he had elected to terminate the adventure, and that either party was free to go on with the enterprise, plaintiff protested and specifically and repeatedly notified A. B. Leach that he could not use the incident of the termination of the option to eliminate the plaintiff from the situation and proceed with the matter for his sole profit.

Leach first attempted to put the plaintiff in default by refusing to indorse the note for $100,000 and then demanding that plaintiff advance the $100,000 then notifying the plaintiff that he refused to exercise the option and significantly stating that either party could

continue the matter; then Levering by representing that Leach was definitely out of the matter and that he must take up the matter with other parties which was impossible while the agreement with plaintiff was outstanding, obtained from plaintiff a release therefrom. We find Levering as soon as he could locate Leach resuming negotiations. Not content to await Leach's return to the city, Levering follows him to his golf club, on Sunday, and exhibits to him the release that he has induced the plaintiff to sign and then resumes the enterprise with the understanding that Leach alone should receive the profit.

It is a well-settled rule that copartners and joint adventurers owe the duty of utmost good faith to their copartners and coadventurers, and that until the copartnership is terminated or joint adventure is abandoned a copartner or joint adventurer cannot act for himself. If he does and thereby obtains for himself the benefits that otherwise would accrue to the partnership or joint adventurers, he would be held liable in equity to account to his copartner or coadventurers. May v. Hettrick Brothers Co., 181 App.Div. 3, 13, 167 N.Y.S. 966; Stem v. Warren, 185 App.Div. 823, 831, 174 N.Y.S. 30.

It is my opinion that A. B. Leach did not observe that good faith with the plaintiff that the law requires of coadventurers, and that with full knowledge of the conditions and with the sole design of excluding the plaintiff from participation in the profits of the enterprise, which the report of the engineer showed to be reasonably certain, he ostensibly withdrew from the enterprise, knowing full well not alone that without his assistance the plaintiff could not carry out the contract of June 27, 1917, but also that in the limited time between the notification of his withdrawal and the day when large payments must be made upon the properties of the Island Oil and Transportation Corporation, Levering would be unable to arrange with others to finance the corporation; that his refusal to go on with the enterprise was for the purpose of eliminating plaintiff from participation in the profits and securing them for himself. The defendants should be required to account to the plaintiff for one-third of the profits of the transaction. Therefore, the judgment and the findings inconsistent with this opinion will be reversed, with costs to the appellant, and an interlocutory judgment entered requiring the defendants to account for one-third of the net profits received by them, from the transactions set forth in the complaint, and appointing a referee to take such account and to report to the court at Special Term with his opinion. Order containing findings and interlocutory judgment to be settled on notice.

CLARK, P. J., DOWLING, SMITH and PHILBIN, JJ., concurred.

Judgment reversed, with costs, and interlocutory judgment directed to be entered as stated in opinion. Order to be settled on notice.[4]

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[4] Motion to dismiss appeal on ground judgment appealed from was interlocutory and no permission to appeal was obtained, granted, without opinion, 228 N.Y. 612, 127 N.E. 909, 1920.

Note, A Partnership and Joint Adventure Distinguished, 1920, 33 Harv.L.Rev. 852; 1920, 33 Harv.L.Rev. 868.

2. CONTRACT LIABILITY OF THE CORPORATION UPON PRE-INCORPORATION AGREEMENTS

(a) *Without Corporate Adoption of The Contract*

O'RORKE v. GEARY.

Supreme Court of Pennsylvania, 1903. 207 Pa. 240, 56 A. 541.

[Assumpsit to recover the amount alleged to be due on a contract for building a bridge.

Rule for judgment for want of a sufficient affidavit of defense. MCCLUNG, J., filed the following opinion:]

"This suit is upon a written agreement, and the main defense is that the defendant did not, in executing the contract, act for himself, but for a corporation to be formed, and that the corporation, and not D. J. Geary, is now liable to the plaintiff for what is due him on said contract. The contract was executed on June 19, 1901. It was between plaintiff, as party of the first part, and 'D. J. Geary for a bridge company to be organized and incorporated,' as party of the second part. It was for the building of a bridge, which it recites the party of the second part 'desires to build across the Allegheny river, and in accordance with specifications and plans * * * heretofore submitted to the party of the first part by the party of the second part.' The work was to be subject to the inspection and approval of P. H. Melvin, his decision to be binding, etc. An estimate was to be made August 1, 1901, and 75 per cent. paid 'by the party of the second part,' and monthly thereafter. Work was to be commenced within 10 days, and completed on or before October 1, 1901. The agreement concludes, 'In witness whereof we have hereunto set our hands and seals,' etc., but is signed simply by plaintiff and defendant without any seal or scroll. * * *

"We have, then, simply the question as to whether or not Geary bound himself or the company to be incorporated for the building of this bridge. When a party is acting for a proposed corporation he cannot, of course, bind it by anything he does at the time, but he may (1) take on its behalf an offer from the other, which, being accepted after the formation of the company, becomes a contract; (2) make a contract at the time binding himself, with the stipulation or understanding that if a company is formed it will take his place, and that then he shall be relieved of responsibility; or (3) bind himself personally without more, and look to the proposed company, when formed, for indemnity. It seems to us that Geary in this case comes within No. 3. The writing is not a mere naked offer to be submitted to the corporation not yet either organized or incorporated, because work was certainly to be begun, and probably completed, before it was possible that this corporation should come into existence. Geary certainly intended himself to pay the 75 per cent. monthly on the estimates. The affidavit of defense says that the company was incorporated before the bridge was completed, but it does not say that it was incorporated before October 1, 1901, when, by the contract, it

was to be completed. It is just as clear that there is no provision for a substitution of responsibility. The corporation might be accepted by O'Rorke and by novation become the party of the second part, or it might, under certain circumstances, become liable to plaintiff without releasing Geary; but there is nothing in the writing which authorizes Geary to substitute at any time another for himself as the responsible party. The bridge company is not mentioned in the contract save when the party of the second part is described as 'D. J. Geary for the bridge company to be formed,' etc.

"In his opinion in Hopkins v. Mehaffy, 11 Merg. & R. 126, Judge Gibson calls attention to the difference between the covenant of an agent who describes himself as contracting for his principal, and the covenant of a principal through the means and by the instrumentality of an agent. We have here no covenant of a principal through an agent, as is shown by the language used, and for the further reason that the alleged principal was not then in existence.

"In many of the discussions of this subject, 'ratification of the act of an unauthorized agent' and 'the responsibility of an undisclosed principal' are spoken of. These references serve in some cases as illustrations of the nature of the responsibility incurred, but, when applied loosely, confuse rather than enlighten. We have no question of ratification, because that implies the existence at the time of a principal who might have given the agent authority. Nor do we have any such thing as an undisclosed principal. There was nothing undisclosed. We have a case that is sui generis. The bridge was for a company that did not then exist, but was to be afterwards organized and incorporated. O'Rorke might have built the bridge and taken the chances of the company paying him, or he might have made a contract by which Geary was to be liable until the company was formed, and then the company was to step into his shoes and relieve him. Neither of these things was done. A third course was adopted whereby Geary became liable personally on the contract, he taking the chances of the incorporation of the company and of its indemnifying him. He is liable to the plaintiff in the present action. * * *

PER CURIAM. On a rule for judgment for want of a sufficient affidavit of defense the court below entered judgment for plaintiff (see opinion filed) for the larger part of his claim. That opinion sufficiently vindicates the judgment.

The assignments of error are overruled, and the judgment affirmed, for the reasons given in the opinion of the court below.

NOTE

(A) "There is a general rule that persons dealing with promoters of corporations to be thereafter formed are allowed the double security of the promoters and the corporation when it comes into being; but where it appears * * * that the contract was made solely on behalf of, and that the credit was extended solely to, a corporation which was then in process of formation and which shortly thereafter procured its charter, the rule does not apply. * * *" Carle v. Corhan, 127 Va. 223, 234, 103 S.E. 699, 1920; Warren, The Progress of the Law: Corporations, 1921, 34 Harv.L.Rev. 282, 289–292. See, also, Ehrich and Bunzl, Promoters' Contracts,

1929, 38 Yale L.J. 1011, 1012–1024; Isaacs, The Promoter: A Legislative Problem, 1925, 38 Harv.L.Rev. 887, 895–898; Note, 1940, 38 Mich.L.Rev. 1266.[5]

(B) Where a promoter induces a person to contract with a corporation he fraudulently represents is to be organized, he is not personally liable on the contract if the other party knew the promoter was not contracting on his own behalf, although the promoter may be liable in tort, for breach of warranty. Weiss v. Baum, 218 App.Div. 83, 217 N.Y.S. 820, 2d Dep't., 1926, Ehrich and Bunzl, Promoters' Contracts, 1929, 38 Yale L.J. 1011, 1018; 1927, 12 Corn.L.Q. 192; 1927, 40 Harv.L.Rev. 780; 1927, 36 Yale L.J. 709.

(C) Promoters may be held liable for damages for breach of contract where they do not organize the corporation within a reasonable time. Kirschmann v. Lediard, 61 Barb. 573, N.Y.Sup.Ct.1872. See, also, Detwiler v. Clune, 77 Cal.App. 562, 247 P. 264, 1926, 1927, 25 Mich.L.Rev. 571.

(D) Promoters may be penalized under the Martin Act (N.Y.General Business Law, art. 23-A, § 352) for making false and misleading statements in the prospectus. "Promoters are under a duty to make reasonable investigation before issuing a prospectus and to the extent that they fail in the performance of their duty, lack of scienter will not relieve them from liability under the Martin Act." People v. The Federated Radio Corporation et al., 244 N.Y. 33, 41, 154 N.E. 655, 1926, 1927, 31 Law Notes 24. See, also, Note, Rex v. Kyslant—A New Golden Rule for Prospectuses, 1932, 45 Harv.L.Rev. 1078; 1931, 40 Yale L.J. 987.

(E) On the liability of promoters for fraud, to persons subscribing to shares after the corporation is formed, see Downey v. Byrd, 171 Ga. 532, 156 S.E. 259, 72 A.L.R. 345, 1930, 1931, 31 Col.L.Rev. 890; 1931, 2 Ga.Lawyer 42; 1931, 26 Ill.L.Rev. 340; accord, Georgia Portland Cement Corporation et al. v. Harris et al., 178 Ga. 301, 173 S.E. 105, 1934. See, also, Note, 1931, 72 A.L.R. 355. The corporation may be held liable for the fraud or misrepresentations of its promoters, as well. See, Note, 1922, 8 Va.L.Rev. 525.

RAMSEY v. BROOKE COUNTY BUILDING & LOAN ASSOCIATION.

Supreme Court of Appeals of West Virginia, 1926.
102 W.Va. 119, 135 S.E. 249, 49 A.L.R. 668.

Action by R. L. Ramsey against the Brooke County Building & Loan Association. Judgment for plaintiff, and defendant brings error.

MILLER, J. Plaintiff, an attorney at law, sued defendant for alleged professional services rendered prior and subsequent to its organization, and for the value of services which, as its attorney elect, he was entitled to render, but which by the wrongful conduct of its officers and directors he was prevented from performing subsequent to such organization.

On the trial below, on a plea of nonassumpsit, plaintiff recovered a verdict and judgment for $850, to reverse which, for alleged errors committed therein, the defendant was granted the present writ of error.

In his bill of particulars filed, two specific items on which plaintiff based his right of action were presented, viz.:

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5 A recent statute enacted in Kansas [Kan.Gen.Stat.Ann., Corrick, Supp.1939, tit. 17, § 2807] relieves a promoter from liability on a contract made on behalf of the corporation once the corporation comes into existence, unless, within thirty days after its organization, the corporation disaffirms the contract. This statute has been criticized, Legis., 1940, 54 Harv.L.Rev. 154.

(1) For legal services rendered as attorney for Brooke County Building & Loan Ass'n from February 1, 1924, to December 31, 1924, for organization of the company, obtaining its charter and the four amendments thereto, drawing the by-laws, and for other services as such attorney, $700.

(2) For failure and neglect of the defendant to procure plaintiff to make abstracts of title and deeds of trust and mortgages in fifty loans made by defendant to borrowers and owners of real estate, as provided in his contract of employment, between the ——— day of February, 1924, and the ——— day of December, 1925, by which he was damaged, $500. * * *

We are aided very little by the briefs and arguments of counsel on the real questions presented by the record, as we conceive them. First, is the defendant liable for the services of counsel rendered in procuring the charter, attending meetings of stockholders and directors, and in the preparation of the constitution and by-laws, such as were rendered by plaintiff, and shown by the record? In the promotion of a corporation, these preliminary services are of course necessary and all important, and there can be no doubt that the promoters, if they employ counsel, are themselves liable therefor personally; but does the corporation itself, in its corporate entity, when its organization is completed and it has adopted or appropriated the work and services of one thus employed, become liable for the reasonable value thereof? We think it is generally so understood, and that corporations so organized do in actual practice assume and pay all the reasonable incorporation expenses, so as to impose the burden on all stockholders alike, and not wholly upon those who promote the organization. It seems to be well settled that a corporation is not bound by contracts made by the promoters on its behalf, unless after organization it ratifies the same. 7 R.C.L. § 59, p. 80, and notes. In England, according to some early cases, contracts of promoters though relating to the organization, and thereafter accepted, became the obligations of the corporation. See a collation of the cases in note to Oakes v. Cattaraugus Water Co., 143 N.Y. 430, 38 N.E. 461, reported and annotated in 26 L.R.A. 544. But this general rule then proving unsatisfactory was modified, and various distinctions were made in subsequent English cases, as the same note shows. The apparent exception to the modified English rule and recognized and followed in a number of our American cases is that when the contract of the promoters relates to the formation of the corporation, obtaining its charter and its subsequent organization, the corporation is liable upon an implied contract for the necessary expenses incurred therein, and which inure to its benefit. Among the cases we will cite are, Little Rock & Ft. Smith R. Co. v. Perry, 37 Ark. 164; Farmers' Bank of Vine Grove v. Smith, 105 Ky. 816, 49 S.W. 810, 88 Am.St.Rep. 341; Low v. Connecticut & Passumpsic Rivers R. R. Co., 45 N.H. 370; Bell's Gap R. R. Co. v. Christy, 79 Pa. 54, 21 Am.Rep. 39. These cases are directly in point on the very proposition relied on here and covered by plaintiff's instructions to the jury as given by the court, and we think are sound in principle. The rule is based on the familiar principle, that one who knowingly accepts the benefits of the labor or services of another or

of a contract made in his behalf is bound in law and morals to pay the one rendering the services reasonable compensation therefor. * * *

The plaintiff's instructions to the jury given by the court correctly propounded the law applicable to the case, as herein announced; those of the defendant rejected did not do so. Wherefore we find no substantial error in the judgment, and the same will be affirmed.[6]

NOTE

(A) "Since a corporation before its organization cannot have agents, and is unable to contract or to be contracted with it is not liable upon any contract which a promoter attempts to make for it, unless it becomes so by its own act after its incorporation is completed. * * * But there are cases where a corporation becomes bound for the contracts of its promoters. While there are many decisions holding corporations liable in such cases, the courts have had great difficulty in finding a scientific or rational basis for sustaining such liability. The usual grounds that have been suggested are ratification, adoption, novation, and that the proposition made to the promoters is a continuing offer to be accepted or rejected by the corporation when it comes into being, and upon acceptance becomes an original contract on its part; and the liability has also been sustained on the ground that the corporation, by accepting the benefits of a contract, takes it cum onere, and is estopped to deny its liability on the contract. * * * But, whatever may be the proper legal theory by which corporations may be bound by the contracts of their promoters, it is necessary in all cases that the corporation should have full knowledge of the facts, or at least should be put upon such notice as would lead, upon reasonable inquiry, to knowledge of the facts. It is obvious that if corporations could be held bound by all the secret undisclosed contracts of their promoters, few men would care to risk subscribing to their capital stock. Such, however, is not the law; and all the cases that we have been able to find held that there must be knowledge on the part of the corporation. * * *" Clifton v. Tomb, 21 F.2d 893, 900, C.C.A.W.Va.1927. See, I Williston, Contracts, Rev.Ed.1936, § 306; Ehrich and Bunzl, Promoters' Contracts, 1929, 38 Yale L.J. 1011, 1024–1046; Richards, The Liability of Corporations on Contracts Made by Promoters, 1905, 19 Harv.L.Rev. 97; Notes, 1922, 17 A.L.R. 452; 1926, 49 A.L.R. 673; 1939, 123 A.L.R. 726; 1918, 3 Corn.L.Q. 292; 1901, 14 Harv.L.Rev. 536.

(B) The English rule, to the effect that a corporation may neither ratify nor adopt a contract made by its promoters on its behalf, but must make a new contract, is followed in Massachusetts. See, Abbott v. Hapgood, 150 Mass. 248, 22 N.E. 907, 5 L.R.A. 586, 15 Am.St.Rep. 193, 1889; Koppel v. Massachusetts Brick Company, 192 Mass. 223, 78 N.E. 128, 1906; Natal Land and Colonization Co., Ltd., v. Pauline Colliery & Development Syndicate, Ltd., 1904, A.C. 120.

GLASS et al. v. NEWPORT CLOTHING CO., INC.

Supreme Court of Vermont, 1939. 110 Vt. 368, 8 A.2d 651.

Action in contract with declaration in common counts, by Barnet Glass and Samuel Lisman, doing business under the firm name and style of Style Shoppe, against the Newport Clothing Company, Inc., for merchandise sold to the defendant. Judgment for plaintiff Barnet Glass in the sum of $190.26 and for the plaintiffs Barnet Glass and

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6 Rehearing denied November 12, 1926. See Comment in, 1927, 11 Mich.L.Rev. 465.

Samuel Lisman, doing business under the firm name and style of Style Shoppe, in the sum of $45.54, and defendant brings exceptions.

Judgment for plaintiff Barnet Glass reversed and judgment for plaintiff Style Shoppe reversed and action dismissed as to such plaintiff.

MOULTON, CHIEF JUSTICE. * * * Stripped of much detail which is immaterial to the decision of this cause, the following facts emerge from the findings:—for some time previous to July, 1936, Dora Toplitt was engaged in the clothing business in Newport under the name of the Newport Clothing Company. After a loss by fire, Michael Toplitt, Dora's husband, called upon the plaintiff Glass and told him that he was about to organize the business as a corporation, and needed some merchandise. Glass agreed to extend credit, and accordingly merchandise was furnished by him to the fair and reasonable value of $190.26, delivered to Toplitt, and charged either to the Newport Clothing Company, or to the then nonexistent Newport Clothing Company, Inc. The latter concern is the defendant herein, and was incorporated under the laws of this State on August 21, 1936, Michael Toplitt becoming its president. All of the merchandise was delivered to Toplitt before this date. The findings state that Toplitt testified in substance that the defendant corporation took over the assets of the Newport Clothing Company, and "while it does not affirmatively appear that the merchandise referred to—ever came into possession of the corporation, however, I find that the same was purchased by and delivered to Mr. Toplitt for the Newport Clothing Co., Inc;" and that "Barnet Glass individually extended such credit to the Newport Clothing Company, Inc."

The defendant corporation was not, and could not have been, a party to the contract of sale, because it was not in being at the time. Holyoke Envelope Co. v. U. S. Envelope Co., 182 Mass. 171, 174, 65 N.E. 54. For the same reason, Toplitt was not, and could not have been, its agent in the transaction. Hall v. Vermont and Massachusetts R. Co., 28 Vt. 401, 406; Security Co. v. Bennington Monument Ass'n, 70 Vt. 201, 206, 40 A. 43. But the defendant would become liable thereon if, after its organization, it expressly or impliedly assumed the obligation, by the adoption or ratification of the contract. Gardiner v. Equitable Office Bldg. Corp'n, 2 Cir., 273 F. 441, 17 A.L.R. 431, 438; Kirkup v. Anaconda Amusement Co., 59 Mont. 469, 197 P. 1005, 17 A.L.R. 441, 446; Ramsey v. Brook County Bldg. & Loan Ass'n, 102 W.Va. 119, 155 S.E. 249, 49 A.L.R. 668, 673. And where a corporation, after organization, accepts the benefit of a contract made in good faith by its promoter in its behalf previous to its organization, and the contract is one which would have been within its corporate powers to make, the inference is justified that it has adopted or ratified such contract. [citing cases.]

There is no finding, and no claim, of an express adoption here; what the plaintiff Glass argues is that the defendant received the merchandise, and hence had the benefit of the contract. But this contention is not borne out by the record. The statement in the findings that Toplitt testified that the corporation took over the assets of the New-

port Clothing Company is not equivalent to a finding that this was the fact, but is only a finding that the witness so testified (see Vilas v. Seith, 108 Vt. 18, 22, 183 A. 854; Peck v. City Trust Co., 104 Vt. 20, 28, 156 A. 403), and indeed there is nothing to show that the merchandise in question was a part of such assets.

While we must indulge all reasonable intendments in favor of the judgment and read doubtful findings so as to support it, if we reasonably can do so, we cannot supply the omission of an essential fact not fairly inferable as resulting from the facts as found. Wright v. Godin, 108 Vt. 23, 26, 182 A. 89; Manley Bros. v. Somers, 100 Vt. 292, 297, 137 A. 336.

The other findings even more effectually dispose of the contention. The burden was upon Glass to prove the necessary elements of his claim; among them, that the corporation received and accepted the merchandise. The finding that it did not affirmatively appear that it ever came into the possession of the corporation amounts to a failure to find the fact. Wright v. Godin, supra; Partridge v. Cole, 98 Vt. 373, 377, 127 A. 653. The argument that what the trial court meant by the word "affirmatively" was that the fact was shown by circumstantial, rather than by direct evidence, is, we think, more ingenious than convincing. "By affirmative proof is meant such evidence of the truth of the matters asserted as tends to establish them, and this regardless of the character of the evidence offered." Jenkins v. Hawkeye Commercial Men's Ass'n, 147 Iowa 113, 124 N.W. 199, 201, 30 L.R.A.,N.S., 1181, 1184.

The finding that the merchandise was purchased by, and delivered to, Toplitt, for the Newport Clothing Co., Inc. adds nothing to the defendant's liability since, as we have seen, the corporation being nonexistent at that time, could not be bound on any theory of agency, in the absence of a subsequent adoption or ratification. And the finding that Glass extended credit to the Newport Clothing Co. Inc., has no greater effect, because this extension of credit to an anticipated, but as yet unborn, debtor is, standing alone, of no avail. The judgment in favor of Glass is not justified by the facts as found. It is, therefore, unnecessary to consider the defendant's exceptions to the findings.

(b) With Corporate Adoption of the Contract

NOTE

Some jurisdictions hold that the corporation, to be bound by the promoters' contract, must formally adopt or assume it. "But none of the authorities go to the extent of holding that a contract between individuals, even though promoters of a corporation and for its supposed benefit, shall become the contract of the corporation thereafter formed and enforceable against it, independent of affirmative action taken in recognition thereof by the corporation itself. * * * The adoption of such a contract is on the theory that the contract made by the promoters is a continuing offer on the part of the other party to the contract unless withdrawn by him, and that it may be accepted and adopted by the corporation after it is created." Kirkup v. Anaconda Amusement Co., 59 Mont. 469, 478, 480, 197 P. 1005, 17 A.L.R. 441, 1921.

McARTHUR v. TIMES PRINTING CO.

Supreme Court of Minnesota, 1892. 48 Minn. 319, 51 N.W. 216.

Appeal from district court, Hennepin county; Canty, Judge.

Action by D. A. McArthur against the Times Printing Company to recover damages for a breach of contract. Judgment for plaintiff. Defendant appeals. Affirmed.

MITCHELL, J. The complaint alleges that about October 1, 1889, the defendant contracted with plaintiff for his services as advertising solicitor for one year; that in April, 1890, it discharged him, in violation of the contract. The action is to recover damages for the breach of the contract. The answer sets up two defenses: (1) That plaintiff's employment was not for any stated time, but only from week to week; (2) that he was discharged for good cause. Upon the trial there was evidence reasonably tending to prove that in September, 1889, one C. A. Nimocks and others were engaged as promoters in procuring the organization of the defendant company to publish a newspaper; that, about September 12th, Nimocks, as such promoter, made a contract with plaintiff, in behalf of the contemplated company, for his services as advertising solicitor for the period of one year from and after October 1st,—the date at which it was expected that the company would be organized; that the corporation was not, in fact, organized until October 16th, but that the publication of the paper was commenced by the promoters October 1st, at which date plaintiff, in pursuance of his arrangement with Nimocks, entered upon the discharge of his duties as advertising solicitor for the paper; that after the organization of the company he continued in its employment in the same capacity until discharged, the following April; that defendant's board of directors never took any formal action with reference to the contract made in its behalf by Nimocks, but all of the stockholders, directors, and officers of the corporation knew of this contract at the time of its organization, or were informed of it soon afterwards, and none of them objected to or repudiated it, but, on the contrary, retained plaintiff in the employment of the company without any other or new contract as to his services.

There is a line of cases which hold that where a contract is made in behalf of, and for the benefit of, a projected corporation, the corporation, after its organization, cannot become a party to the contract, either by adoption or ratification of it. Abbott v. Hapgood, 150 Mass. 248, 22 N.E. 907; Beach, Corp. § 198. This, however, seems to be more a question of name than of substance; that is, whether the liability of the corporation, in such cases, is to be placed on the grounds of its adoption of the contract of its promoters, or upon some other ground, such as equitable estoppel. This court, in accordance with what we deem sound reason, as well as the weight of authority, has held that, while a corporation is not bound by engagements made on its behalf by its promoters before its organization, it may, after its organization, make such engagements its own contracts. And this it may do precisely as it might make similar original contracts;

formal action of its board of directors being necessary only where it would be necessary in the case of a similar original contract. That it is not requisite that such adoption or acceptance be express, but it may be inferred from acts or acquiescence on part of the corporation, or its authorized agents, as any similar original contract might be shown. Battelle v. Pavement Co., 37 Minn. 89, 33 N.W. 327. See, also, Mor. Corp. § 548. The right of the corporate agents to adopt an agreement originally made by promoters depends upon the purposes of the corporation and the nature of the agreement. Of course, the agreement must be one which the corporation itself could make, and one which the usual agents of the company have express or implied authority to make. That the contract in this case was of that kind is very clear; and the acts and acquiescence of the corporate officers, after the organization of the company, fully justified the jury in finding that it had adopted it as its own. * * *

The point is made that plaintiff should have alleged that the contract was made with Nimocks, and subsequently adopted by the defendant. If we are correct in what we have said as to the legal effect of the adoption by a corporation of a contract made by a promoter in its behalf before its organization, the plaintiff properly pleaded the contract as having been made with the defendant. But we do not find that the evidence was objected to on the ground of a variance between it and the complaint. The assignments of error are very numerous, but what has been already said covers all that are entitled to any special notice. Order affirmed.

BRYAN v. NORTHWEST BEVERAGES, Inc.

Supreme Court of North Dakota, 1939. 69 N.D. 274, 285 N.W. 689.

Appeal from District Court, Burleigh County; R. G. McFarland, Judge.

Action by Leon Bryan against Northwest Beverages, Incorporated, on a quantum meruit to recover the reasonable value of services performed by the plaintiff in behalf of the defendant corporation and of the good will and accounts conveyed by him to the defendant corporation. Judgment for plaintiff on a verdict for $4,500, and the defendant appeals.

Affirmed.

ENGLERT, DISTRICT JUDGE. This is an action upon a quantum meruit. It was brought by the plaintiff to recover "the reasonable value of the services performed by him for and in behalf of the defendant corporation and of the good will and accounts conveyed by him to said corporation."

The answer of the defendant amounts to a general denial of the complaint. It alleges the defendant employed the plaintiff as a salesman at a salary of a hundred and fifty dollars per month, and that the defendant was obliged to terminate his services because he refused to carry out the instructions of the board of directors, and that he has been fully paid for all services he performed for defendant. * * *

The complaint alleges that after the incorporation of the defendant, the plaintiff turned over to the defendant accounts of persons engaged in the retail liquor business, and who were making purchases in the sum of $200,000 worth per year, and that the defendant accepted and adopted the contract by issuing the stock in the name of the plaintiff on its books, and employing him as manager of the defendant company. The defendant maintains that in order to hold it liable on the alleged contract, plaintiff must allege formal adoption of the agreement by its board of directors. It cites and relies upon the case of Kirkup v. Anaconda Amusement Co., 59 Mont. 469, 197 P. 1005, 1008, 17 A.L.R. 441, as authority for such contention. In that case the court held that the demurrer to the complaint should have been sustained. In that case, the complaint contained no such allegation as above mentioned. Moreover, in the case before us, the plaintiff testified that, at a meeting of all the stockholders and officers of the corporation on November 15, 1936, all the stockholders agreed to accept and to adopt the preincorporation agreement made by the plaintiff with the other organizers.

The court, in the Kirkup case, quoted from the decision in Fitzpatrick v. O'Neill, 43 Mont. 552, 118 P. 273, Ann.Cas.1912C, 296, so far as material, the following: "Appellants maintain that the directors alone possess the power to bind the corporation in this regard. * * * It is not the universal rule that the corporation must act exclusively through its board of directors. 'Formal action is often dispensed with, even in the most important matters, where all the members of the corporation, including the shareholders and directors, are present and concur, although there is no formal vote either of the shareholders or of the directors.' " After thus quoting from the Fitzpatrick case, the court in the Kirkup case said: "The authority of this case, cited and relied upon by the plaintiff, it will readily be seen, has no application to the case under consideration, as there is no contention made by allegations of the complaint, or otherwise, that the contract was assumed or adopted by all of the directors of the corporation, or all of its stockholders. Were such facts made to appear, a different conclusion would doubtless be reached, upon this phase of the case, even in the absence of formal action by the board of directors or stockholders."

A careful examination of the complaint in question convinces us that the objections urged against it by the defendant are groundless and without merit. * * *

This disposes of the errors assigned by the appellant adversely to its contentions. The judgment and order appealed from should be affirmed, with costs to the plaintiff. It will be so ordered.

JOHNSON & CARLSON v. MONTREUIL'S ESTATE.

Supreme Court of Michigan, 1939. 291 Mich. 582, 289 N.W. 262.

Johnson & Carlson filed a claim against the Estate of Albert T. Montreuil, deceased, for balance due on brewery equipment, installed in the plant of the Albert Brewing Company, on the ground that the

order for the equipment and circumstances surrounding the same imposed personal liability on deceased. From judgment in probate court and on appeal in circuit court disallowing the claim, the plaintiff appeals.

Affirmed.

WIEST, JUSTICE. Plaintiff filed a claim against the estate of Albert T. Montreuil, deceased, for balance due on brewery equipment, installed in the plant of the Albert Brewing Company, in Detroit, on the ground that the order for the equipment and circumstances surrounding the same imposed personal liability on Mr. Montreuil. The claim was disallowed in the probate court and on appeal in the circuit court and is here by appeal.

February 27, 1936, plaintiff sent a written proposition to the Mundus Brewing Company, at Detroit, covering the equipment and price thereof installed.

Mr. Montreuil was interested in the formation of a new brewing corporation in place and stead of the Mundus Brewing Company and, on March 3, 1936, he signed and sent the following order to plaintiff:

"Gentlemen:

"I beg to place an order with you for nine closed fermenting ale tanks, as described in your letter addressed to the Mundus Brewing Company dated February 27th, and also 32 open fermenters and three oval open fermenters, as also described in the said letter, the bottoms and heads to be made from 3″ material and the staves to be of 2½″ material.

"I am placing this order now in order to save time and I may state that just as soon as the new brewing company is organized at the first meeting of the board of directors this order will be confirmed by them.

"Yours very truly,

"A. T. Montreuil.

"P.S. The total barrelage capacity of the above tanks will be 6,040 barrels, and the price is to be $23,625."

The new corporation, styled the Albert Brewing Company, was organized three days later, and the equipment was installed in the plant of that company and billed to it, and that company paid the bill in part and for the balance executed a series of notes sent to it by plaintiff. The new corporation became bankrupt and plaintiff presented its claim against it in the bankruptcy proceeding, and also presented the same claim against the Estate of Albert T. Montreuil, deceased, claiming that the order by Mr. Montreuil was given as a promoter of the corporation and constituted a contract between him and plaintiff.

Contemporaneous action demonstrating the purpose and understanding of the scope of the order and the relation and liability of the parties thereunder carries meaning wholly inconsistent with plaintiff's present desire.

The order given in behalf of the contemplated corporation, in fact later organized, and followed by delivery to and installation in the plant of the new company, brought no liability to Mr. Montreuil, act-

ing in behalf of the corporation subsequently organized, in the absence of his personal pledge.

In the instance at bar, under the express terms of the order, it was solely for and in behalf of the corporation to be organized and on its face negatived any other relation. * * *

Plaintiff contends that there can be no agency in behalf of a non-existing principal. This must be qualified by stating, unless sanctioned by law.

This common law rule evidently accounts for the enactment of § 8, Act No. 327, Pub.Acts 1931, Stat.Ann. § 21.8, as a part of the general corporation act serving as a charter for Michigan corporations. That section provides: "No contract made by the incorporators for or on behalf of any corporation to be formed preliminary to the filing of the articles shall be deemed to be invalid or ineffectual because made prior to such filing, and all property held by such incorporators for the benefit of the proposed corporation shall be deemed to be the property of such corporation."

This statute enables the incorporators to make valid contracts, "for or on behalf of any corporation to be formed preliminary to the filing of the articles", and abrogates the common law rule invoked by plaintiff to the effect that promoters may make no contract in behalf of a proposed corporation. Under this statute the order in behalf of the contemplated corporation, upon organization of such corporation, by adoption and the acts of the parties, became a contract exclusively between such corporation and plaintiff.

Questions raised relative to admission and exclusion of evidence have been examined and, under the disposition we make of the case, are of no moment.

The judgment is affirmed, with costs.

(c) Implied Corporate Adoption of the Contract

MORGAN v. BON BON COMPANY.

Court of Appeals of New York, 1917. 222 N.Y. 22, 118 N.E. 205.

Action by Harlan D. Morgan against the Bon Bon Company, Incorporated. From a judgment of the Appellate Division (165 App. Div. 89, 150 N.Y.S. 668) reversing a judgment in favor of plaintiff and dismissing his complaint, the plaintiff appeals. Judgment of the Appellate Division reversed, and that of the trial court affirmed.

HISCOCK, C. J. The appellant recovered a judgment against the respondent because the latter refused to deliver to him certain shares of its capital stock in payment for services rendered in accordance with the terms of a contract made between the appellant and the organizers of the respondent, and the obligations of which contract it is claimed the latter had assumed. To the reasons assigned for the reversal of the judgment by the Appellate Division others are now added in the argument made by the respondent for the affirmance of

such judgment, and all of these will be briefly considered after a statement of the essential facts.

Four men made a contract for the organization of the respondent whereby, amongst other things, loans by one of the number to the corporation were provided for. At or before the time when this agreement was executed one of the four in substance proposed that appellant should be employed to lay out and put into operation a system of bookkeeping for the corporation thus to be organized. The result of this proposition was that there was added to the principal agreement a supplementary paragraph, which is the important one in this litigation, and whereby it was provided:

"It is understood between the undersigned, organizers of the Bon Bon Company, that after the company shall have repaid to A. Maynard Lyon all the advances that he shall make to said company, and its other debts, there shall be issued to George W. Felter seventy-five shares of the stock of said company, and to Harlan D. Morgan twenty-five shares of the stock of said company, in payment of the amounts to become due to them from said company for services to be rendered by them to the company, to its satisfaction."

On the day this agreement was executed the respondent corporation was organized; all of its stock then issued being issued to the four organizers who for the term of at least a year were its directors and officers. After the corporation was organized the appellant performed for it the services above indicated, and this was done with the knowledge and apparent approval of the officers of the corporation who as organizers had made the contract with him, and were, of course, fully cognizant of the terms thereof. These services were continued until the appellant was advised that no more were needed, and after a lapse of considerable time, the respondent having refused to deliver to him the shares of stock provided by the contract, this action was brought wherein damages were recovered for such failure on a valuation of much more than the par value of the stock.

It is urged in behalf of the respondent that the complaint does not sufficiently allege any adoption by the corporation of the terms and obligations of the contract made by the men who organized it with the appellant; that there was no evidence of any action by the respondent which resulted in the adoption of the contract and in imposing upon it the obligation to carry out the terms thereof; that the contract provided for the issue of stock with which to pay for services to be rendered in the future, and that this was unlawful; that the contract, even though otherwise binding, was invalidated by the fact that the services performed by appellant were worth much less than the par value of the stock agreed to be issued in payment therefor. We do not think that any of these defensive contentions can be sustained.

While it is true that the complaint does not in terms allege that the respondent adopted and became bound by the terms of the contract made by its organizers with appellant, we think that it does set forth fairly well the facts upon which this conclusion and claim can be predicated. Moreover, as a material justification for this inter-

pretation it is to be noted that all of the facts entering into the controversy between the parties were admitted or proven without any objection that evidence thereof was inadmissible under the complaint.

We think that the evidence thus admitted did permit the jury to find that the respondent had adopted the contract made by its organizers with the appellant and had become bounden by the terms thereof. These organizers became the corporation. The contract was made in view of the organization of the respondent and for its benefit. With the knowledge and approval of the men who organized the corporation and then became its stockholders and officers, the appellant was permitted to perform the services which had been contracted for, and the corporation, chargeable through its officers with full knowledge of the contract under which these services were being rendered, received the benefit thereof. It is well established that a corporation which under such circumstances takes the benefits of a contract may be held to have adopted and assumed also its obligations. Morawetz on Private Corporations (2d Ed.) § 549; Cook on Corporations, § 707; Bommer v. Am. Spiral Spring B. H. Mfg. Co., 81 N.Y. 468, 473; Burden v. Burden, 8 App.Div. 160, 167, 40 N.Y.S. 499, affirmed 159 N.Y. 287, 54 N.E. 17; Oakes v. Cattaraugus Water Co., 143 N.Y. 430, 38 N.E. 461, 26 L.R.A. 544; Rogers v. N. Y. & Texas Land Co., 134 N.Y. 197, 211, 32 N.E. 27; Shaffer v. Mohawk Valley Br. Corp., 221 N.Y. 697, 117 N.E. 1084. * * *

We think that the judgment of the Appellate Division should be reversed, and that of the trial court affirmed, with costs in this court and in the Appellate Division.

MCLAUGHLIN, J. (dissenting). I am unable to concur in the opinion of the Chief Judge that the judgment here appealed from should be reversed. The agreement upon which the liability of the defendant is predicated is, upon its face, one between the organizers of the defendant and no one else. It in no way purports to bind the corporation or to have been executed on its behalf. The only reference to the plaintiff is that after the corporation shall have repaid Lyon for the money loaned by him to it, and paid its other debts, there shall be issued to the plaintiff 25 shares of stock "for services to be rendered." The agreement was executed prior to the organization of the defendant, and on the very day it was entered into all of the stock was issued to the organizers, and by them put up as collateral to secure the payment of the money advanced by Lyon. After the corporation was organized the plaintiff installed a system of bookkeeping and opened a set of books for it. These were the services which he performed and for which it is claimed he has a right to recover under the agreement, on the theory that the corporation adopted such agreement because the organizers constituted the board of directors or officers of the corporation during the time the services were rendered. This is the only evidence there is bearing upon the question of adoption. There is nothing to show corporate action of any kind other than that the organizers of the corporation acted in the capacity referred to.

The action is upon the agreement, not to recover for the value of the services rendered, and before such action can be maintained some-

thing more, I think, must be shown. Allegations to the effect that the persons executing the agreement organized the corporation, that one of their number thereafter loaned money to it, that all of them became officers or directors, and acted as such during the time the services were rendered, seem to me quite insufficient to warrant a finding that the corporation adopted the agreement, and thereby became bound by it. Obviously an agreement between the organizers of a corporation to the effect that after the organization is completed the stock shall be issued in a certain way is not binding upon the corporation. Once the corporation is organized the statute states for what the stock may be issued. Stock Corp. Law, c. 564, Laws of 1890, as amended by chapter 354, Laws of 1901; Consol.Laws, c. 59, § 55. The language is:

"No corporation shall issue either stock or bonds except for money, labor done or property actually received for the use and lawful purposes of such corporation."

When the agreement referred to was made, the corporation was not organized; the services had not been rendered; and the fact that services were thereafter rendered, of which the corporation had the benefit, obligated it, in my opinion, to do, not what the agreement provided (deliver to plaintiff 25 shares of its stock), but to pay him what his services were worth.

It is not difficult to imagine, if the plaintiff here can recover from the corporation 25 shares of its stock, how easily the provisions of the statute above quoted can be evaded. Assume that the promoters, instead of agreeing among themselves to give the plaintiff 25 shares for services to be rendered by him, had agreed to give him substantially all of the stock for the same services. What would there have been left after the agreement had been carried out by the corporation? It would have adopted a system of bookkeeping and opened a set of books, and had an empty treasury. Not only this, but the plaintiff, his action being predicated upon the agreement, must have known when the services were rendered by him that the corporation having issued all of its stock could not deliver to him the 25 shares which the organizers had agreed to.

For these reasons, as well as those given in the prevailing opinion of the Appellate Division, I dissent, and vote to affirm the judgment appealed from.

KENYON v. HOLBROOK MICROFILMING SERVICE.

Circuit Court of Appeals of the United States, Second Circuit, 1946. 155 F.2d 913.

Appeal from the District Court, of the United States for the Southern District of New York.

Action by Frank C. Kenyon against Holbrook Microfilming Service, Inc., to recover salary allegedly due under a contract of employment and for damages resulting from its breach. From a judgment, entered upon a directed verdict, dismissing the complaint, the plaintiff appeals.

Affirmed.

L. HAND, CIRCUIT JUDGE. The plaintiff, Kenyon, appeals from a judgment against him in an action to recover salary due under a contract of employment by the defendant, and for damages resulting from its breach. The cause was brought in the state court and removed to the district court for diversity of citizenship; and at the conclusion of the evidence the judge directed a verdict because the plaintiff had failed to make out a cause of action. That is the only point involved. The defendant is a Delaware corporation organized in November, 1942, at the instance of Kathleen Hogan and Fred Lhoyd, the actual incorporators being three dummies, who acted throughout at their direction, and who may be disregarded. Hogan and Lhoyd obtained licenses upon several "microfilm" patents; and some time between November, 1942 and July 12, 1943, they got an option for the purchase of a New York company, engaged in the manufacture of "microfilm" whose business they expected to continue under the new corporation. They met Kenyon in February, 1943, and had several interviews with him in which they persuaded him to become president of the new company. On March 11th, they executed a contract, the substance of which is set forth in the margin; and for two months beginning April 16th, when he definitely gave up his position in another company, he was steadily engaged in various kinds of work for the corporation. Part of this was the preparation of a prospective "budget" for the first year of operations, showing in detail the necessary capital outlay, the "break-even point," a detailed analysis of the expected profits, a summary of profit and loss and concluding with a "Maximum Cash Absorption during first year" of about $135,000. * * *

Kenyon first argues that the contract of March 11, 1943, bound the defendant, regardless of ratification by the company's board of directors: this on the theory that Hogan and Lhoyd were the incorporators, and as such had power to commit the corporation. That is a question of Delaware law and, as we are not referred to any decisions of that state which touch upon the point, we are thrown back upon the statutes. The answer is clear: incorporators as such have no power to appoint a president and fix his salary before a board of directors is appointed. We quote § 8 of the Delaware Corporation Law, Rev.Code 1935, § 2040, in the margin.[3] The phrase, "direction of the affairs" of the corporation, even though it stood alone, could not really be thought to allow the incorporators to start the business at once, even before the stock had been subscribed and the directors elected; but it does not stand alone. The context shows that what is meant is that the incorporators shall have charge of so much as is necessary to start the business going by getting in the money and electing the board. Moreover, it so happens that § 10 of the Delaware Corporation Law, Rev.Code 1935, § 2042, expressly provides that the directors or shareholders are to elect the president. Hence, if

[3] "Until the directors are elected, the signers of the certificate of incorporation shall have the direction of the affairs and of the organization of the corporation, and may take such steps as are proper to obtain the necessary subscriptions to stock and to perfect the organization of the corporation, including the election of directors."

the defendant is to be held at all, it can only be on the theory that it ratified the contract made on its behalf by Hogan and Lhoyd. That the board of directors never did formally ratify the contract is undoubted; there was no board until July 12th, and Kenyon had already withdrawn from the business on June 18th. To avoid this embarrassment he argues first, that Raskob and Hogan tricked him into this withdrawal; and second, that Raskob had in fact ratified the contract before June 18th, in particular by making use of the prospective "budget." The second argument implies that Raskob's knowledge of the contract and his conduct thereafter was a ratification, although it took place before the stock was issued, or the directors elected. * * *

There is not a tittle of evidence that Raskob ratified the contract before June 18th. He had at once refused to guarantee the Robinson Foundation's suggested financing; and as soon as he heard of Kenyon's contract he disapproved of that too. Whether a use of the "budget" after Raskob had agreed to finance the company, would have been a ratification, if Kenyon had not in the meantime withdrawn, is another matter; but until Raskob had so agreed, the use he made of it had no effect upon his obligations or the defendant's. Moreover, when Kenyon "dropped out," he abandoned whatever he had done—the "budget" included—and Raskob might use it as he chose. Whatever claim Kenyon had against Hogan and Lhoyd, he has none against the defendant; and the appeal is totally without merit.

Judgment affirmed.

WELLS et al. v. J. A. FAY & EGAN COMPANY.

Supreme Court of Georgia, 1915. 143 Ga. 732, 85 S.E. 873.

Action by the J. A. Fay & Egan Company against L. M. Wells and others. Judgment for plaintiff, and defendants bring error. Affirmed.

EVANS, P. J. The J. A. Fay & Egan Company brought suit against L. M. Wells and others, alleging that the defendants, under the partnership name of Ficklen Spoke & Handle Company, purchased from the plaintiff certain machinery, for which they gave their notes, copies of which were attached. Judgment was prayed for the amount claimed to be due on the notes. Four of the defendants pleaded that they were not indebted to the plaintiff, denied the alleged partnership, and averred that the Ficklen Spoke & Handle Company was a corporation. The jury returned a verdict for the plaintiff.

1. It appeared from the evidence that the defendants promoted the organization of a corporation, and on March 23, 1909, authorized the purchase of certain machinery from the plaintiff; the contract of purchase being in writing and signed "Ficklen Spoke & Handle Company, by L. M. Wells." The machinery was shipped and received by the defendants, and on June 22, 1909, the notes in suit were executed by authority of the defendants; these notes being

signed "Ficklen Spoke & Handle Co., per R. K. Carruth, Sec. & Treas." Subsequently, to wit, August 26, 1909, on the application of the defendants, they were granted a charter, and later perfected an organization of the corporation. These facts are not in dispute, and their effect is to charge the defendants with liability on the notes. Persons acting in concert to bring about the formation of a corporation are responsible for their acts. Where they buy machinery, receive it into their possession, and authorize one of their number to give a note for the purchase price, they cannot escape liability on the theory that they contemplated the organization of a corporation for which they intended the machinery. If one contracts as agent, when in fact he has no principal, he will be personally liable. A promoter, though he may assume to act on behalf of the projected corporation and not for himself, cannot be treated as an agent of the corporation, for it is not yet in existence; and he will be personally liable on his contract, unless the other party agreed to look to some other person or fund for payment. Clark on Contracts, § 47.

2. But it is contended that, after the corporation was formed, it made certain payments on the notes, which were accepted by the plaintiff, and that the plaintiff undertook to place the corporation into a receivership because of its default in the payment of the notes, which were alleged to be its debt; and that these facts estop the plaintiff from asserting a personal liability against the defendants. Clearly the acceptance by a creditor of a partial payment from a stranger will not extinguish the balance due on the debtor's obligation. Nor do we see how the plaintiff's efforts to collect its debt from the corporation will serve to release the defendants. The pleadings in that case are not in the record, and, for aught we know, the plaintiff was attempting in that suit to fix the corporation's liability on the ground that it had adopted the contract of the promoters after its organization. There is nothing in the evidence which will afford an inference that the plaintiff released the defendants from their contract. * * *

Judgment affirmed.

C. THE NATURE OF THE CORPORATE CONTRACT

TRUSTEES OF DARTMOUTH COLLEGE v. WOODWARD

Supreme Court of the United States, 1819. 4 Wheat. 518, 4 L.Ed. 629.

[The statement of facts is omitted].

MR. CHIEF JUSTICE MARSHALL, delivered the opinion of the court: This is an action of trover, brought by the trustees of Dartmouth College against William H. Woodward, in the State Court of New Hampshire, for the book of records, corporate seal, and other corporate property, to which the plaintiffs allege themselves to be entitled.

A special verdict, after setting out the rights of the parties, finds for the defendant, if certain acts of the legislature of New Hampshire,

passed on the 27th of June, and on the 18th of December, 1816, be valid, and binding on the trustees without their assent, and not repugnant to the constitution of the United States; otherwise, it finds for the plaintiffs.

The Superior Court of Judicature of New Hampshire rendered a judgment upon this verdict for the defendant, which judgment has been brought before this court by writ of error. The single question now to be considered is, do the acts to which the verdict refers violate the constitution of the United States?

This court can be insensible neither to the magnitude nor delicacy of this question. The validity of a legislative act is to be examined; and the opinion of the highest law tribunal of a state is to be revised: an opinion which carries with it intrinsic evidence of the diligence, of the ability, and of the integrity, with which it was formed. On more than one occasion this court has expressed the cautious circumspection with which it approaches the consideration of such questions; and has declared that, in no doubtful case would it pronounce a legislative act to be contrary to the constitution. But the American people have said, in the Constitution of the United States, that "no state shall pass any bill of attainder, ex post facto law, or law impairing the obligation of contracts." In the same instrument they have also said, "that the judicial power shall extend to all cases in law and equity arising under the constitution." On the judges of this court, then, is imposed the high and solemn duty of protecting, from even legislative violation, those contracts which the constitution of our country has placed beyond legislative control; and, however irksome the task may be, this is a duty from which we dare not shrink.

The title of the plaintiffs originates in a charter dated the 13th day of December, in the year 1769, incorporating twelve persons therein mentioned, by the name of "The Trustees of Dartmouth College," granting to them and their successors the usual corporate privileges and powers, and authorizing the trustees, who are to govern the college, to fill up all vacancies which may be created in their own body.

The defendant claims under three acts of the legislature of New Hampshire, the most material of which was passed on the 27th of June, 1816, and is entitled, "an act to amend the charter, and enlarge and improve the corporation of Dartmouth College." Among other alterations in the charter, this act increases the number of trustees to twenty-one, gives the appointment of the additional members to the executive of the state, and creates a board of overseers, with power to inspect and control the most important acts of the trustees. This board consists of twenty-five persons. The president of the senate, the speaker of the house of representatives, of New Hampshire, and the Governor and Lieutenant-Governor of Vermont, for the time being, are to be members ex officio. The board is to be completed by the Governor and council of New Hampshire, who are also empowered to fill all vacancies which may occur. The acts of the 18th and 26th of December are supplemental to that of the 27th of June, and are principally intended to carry that act into effect.

The majority of the trustees of the college have refused to accept this amended charter, and have brought this suit for the corporate property, which is in possession of a person holding by virtue of the acts which have been stated.

It can require no argument to prove that the circumstances of this case constitute a contract. An application is made to the crown for a charter to incorporate a religious and literary institution. In the application, it is stated that large contributions have been made for the object, which will be conferred on the corporation as soon as it shall be created. The charter is granted, and on its faith the property is conveyed. Surely in this transaction every ingredient of a complete and legitimate contract is to be found:

The points for consideration are:

1. Is this contract protected by the constitution of the United States?

2. Is it impaired by the acts under which the defendant holds? * * *

It becomes, then, the duty of the court most seriously to examine this charter, and to ascertain its true character. * * *

This is plainly a contract to which the donors, the trustees, and the crown (to whose rights and obligations New Hampshire succeeds), were the original parties. It is a contract made on a valuable consideration. It is a contract for the security and disposition of property. It is a contract, on the faith of which real and personal estate has been conveyed to the corporation. It is then a contract within the letter of the constitution, and within its spirit also, unless the fact that the property is invested by the donors in trustees for the promotion of religion and education, for the benefit of persons who are perpetually changing, though the objects remain the same, shall create a particular exception, taking this case out of the prohibition contained in the constitution. * * *

The opinion of the court, after mature deliberation, is, that this is a contract, the obligation of which cannot be impaired without violating the Constitution of the United States. This opinion appears to us to be equally supported by reason, and by the former decisions of this court. * * *

WASHINGTON, J.: * * * There are, then, two questions for this court to decide:

1st. Is the charter granted to Dartmouth College on the 13th of December, 1769, to be considered as a contract? If it be, then 2d., Do the laws in question impair its obligation?

1. What is a contract? It may be defined to be a transaction between two or more persons, in which each party comes under an obligation to the other, and each reciprocally acquires a right to whatever is promised by the other. Under this definition, says Mr. Powell, it is obvious that every feoffment, gift, grant, agreement, promise, etc., may be included, because in all there is a mutual consent of the minds of the parties concerned in them, upon an agreement, between them respecting some property or right that is the object of the stipulation. He adds, that the ingredients requisite to form a

contract, are parties, consent, and an obligation to be created or dissolved; these must all concur, because the regular effect of all contracts is on one side to acquire, and on the other to part with, some property or rights; or to abridge, or to restrain natural liberty, by binding the parties to do, or restraining them from doing, something which before they might have done, or omitted. If a doubt could exist that a grant is a contract, the point was decided in the case of Fletcher v. Peck, 6 Cranch, 87, 3 L.Ed. 162, in which it was laid down that a contract is either executory or executed; by the former, a party binds himself to do or not to do a particular thing; the latter is one in which the object of the contract is performed, and this differs in nothing from a grant; but whether executed or executory, they both contain obligations binding on the parties, and both are equally within the provisions of the Constitution of the United States, which forbids the state governments to pass laws impairing the obligation of contracts.

If, then, a grant be a contract, within the meaning of the Constitution of the United States, the next inquiry is, whether the creation of a corporation by charter be such a grant as includes an obligation of the nature of a contract, which no state legislature can pass laws to impair.

A corporation is defined by Mr. Justice Blackstone to be a franchise. "It is," says he, "a franchise for a number of persons, to be incorporated and exist as a body politic, with a power to maintain perpetual succession, and to do corporate acts, and each individual of such corporation is also said to have a franchise, or freedom." This franchise, like other franchises, is an incorporeal hereditament, issuing out of something real or personal, or concerning or annexed to, and exercisable within a thing corporate. To this grant, or this franchise, the parties are, the king, and the persons for whose benefit it is created, or trustees for them. The assent of both is necessary. The subjects of the grant are not only privileges and immunities, but property, or, which is the same thing, a capacity to acquire and hold property in perpetuity. Certain obligations are created, binding both on the grantor and the grantees. On the part of the former, it amounts to an extinguishment of the king's prerogative to bestow the same identical franchise on another corporate body, because it would prejudice his prior grant. It implies, therefore, a contract not to re-assert the right to grant the franchise to another, or to impair it. There is also an implied contract, that the founder of a private charity, or his heirs, or other persons appointed by him for that purpose, shall have the right to visit, and to govern the corporation, of which he is the acknowledged founder and patron, and also, that in case of its dissolution, the reversionary rights of the founder to the property, with which he had endowed it, should be preserved inviolate.

The rights acquired by the other contracting party are those of having perpetual succession, of suing and being sued, of purchasing lands for the benefit of themselves and their successors, and of having a common seal, and of making by-laws. The obligation imposed upon

them, and which forms the consideration of the grant, is that of acting up to the end or design for which they were created by their founder. Mr. Justice Buller, in the case of King v. Passmore, 3 T.R. 246, says, that the grant of a corporation is a compact between the crown and a number of persons, the latter of whom undertake, in consideration of the privileges bestowed, to exert themselves for the good government of the place, if they fail to perform their part of it, there is an end of the compact. The charter of a corporation, says Mr. Justice Blackstone, 2 Bl.Com. 484, may be forfeited through negligence, or abuse of its franchises, in which case the law judges that the body politic has broken the condition upon which it was incorporated, and thereupon the corporation is void.

It appears to me, upon the whole, that these principles and authorities prove, incontrovertibly, that a charter of incorporation is a contract. * * *

It has been shown that the charter is a contract on the part of the government, that the property with which the charity is endowed shall be forever vested in a certain number of persons, and their successors, to subserve the particular purposes designated by the founder, and to be managed in a particular way. If a law increases or diminishes the number of the trustees, they are not the persons which the grantor agreed should be the managers of the fund. If it appropriate the fund intended for the support of a particular charity to that of some other charity, or to an entirely different charity, the grant is in effect set aside, and a new contract substituted in its place; thus disappointing completely the intentions of the founder, by changing the objects of his bounty. And can it be seriously contended that a law which changes so materially the terms of a contract does not impair it? In short, does not every alteration of a contract, however unimportant, even though it be manifestly for the interest of the party objecting to it, impair its obligation? If the assent of all the parties to be bound by a contract be of its essence, how is it possible that a new contract, substituted for, or engrafted on another, without such assent, should not violate the old charter?

This course of reasoning, which appears to be perfectly manifest, is not without authority to support it. Mr. Justice Blackstone, lays it down, 2 Bl.Com. 37, that the same identical franchise, that has been before granted to one, cannot be bestowed on another; and the reason assigned is, that it would prejudice the former grant. In the King v. Passmore, 3 T.R. 246, Lord Kenyon says, that an existing corporation cannot have another charter obtruded upon it by the crown. It may reject it, or accept the whole, or any part of the new charter. The reason is obvious. A charter is a contract, to the validity of which the consent of both parties is essential, and, therefore, it cannot be altered or added to without such consent.

But the case of Terrett v. Taylor, 9 Cranch, 43, 3 L.Ed. 650, fully supports the distinction above stated, between civil and private corporations, and is entirely in point. It was decided in that case, that a private corporation, created by the legislature, may lose its franchises by misuser, or nonuser, and may be resumed by the govern-

ment under a judicial judgment of forfeiture. In respect to public corporations which exist only for public purposes, such as towns, cities, etc., the legislature may, under proper limitations, change, modify, enlarge, or restrain them, securing, however, the property for the use of those for whom, and at whose expense, it was purchased. But it is denied that it has power to repeal statutes creating private corporations, or confirming to them property already acquired under the faith of previous laws; and that it can, by such repeal, vest the property of such corporations in the state, or dispose of the same to such purposes as it may please, without the consent or default of the corporators. Such a law, it is declared, would be repugnant both to the spirit and the letter of the constitution of the United States.

If these principles, before laid down, be correct, it cannot be denied that the obligations of the charter to Dartmouth College are impaired by the laws under consideration. * * *

Upon the whole, I am of opinion that the above acts of New Hampshire, not having received the assent of the corporate body of Dartmouth College, are not binding on them, and, consequently, that the judgment of the state court ought to be reversed.

JOHNSON, J., concurred, for the reasons stated by the CHIEF JUSTICE.

LIVINGSTON, J., concurred, for the reasons stated by the CHIEF JUSTICE, and JUSTICES WASHINGTON and STORY. * * *

DUVALL, J., dissented. * * *

NOTE

THE "CORPORATE CONTRACT"

The established doctrine is that a certificate of incorporation is a "contract". The word, as applied in this connection, has the eminent sponsorship of Chief Justice Marshall in the Dartmouth College case. With the word "contract" in their teeth, lawyers and judges proceeded to push the idea: "It is a well recognized principle of law that 'the charter of a corporation having a capital stock is a contract between three parties and forms the basis of three distinct contracts. The charter is a contract between the state and the corporation; second, it is a contract between the corporation and the stockholders; third, it is a contract between the stockholders and the state'". Thus the Court, in Garey v. St. Joe Mining Company, 32 Utah 497, 505, 91 P. 369, 371 (1907), quoting from 2 Cook on Corporations (5th edition) § 492.

This is all very well until it is examined analytically. Under a microscope it does not seem quite so clear. "Contract" can cover both generic classes of arrangements such as grants (a deed or gift is generically a "contract") and the more specialized agreements between parties binding both, of which the ordinary commercial contract is the classic example. Clearly lawyers and judges pushed Chief Justice Marshall's word from the generic into the commercial category; and difficulties appear at once. In the latter sense, a "contract" presupposes two parties able to contract; yet the corporation is not in existence; and until the state creates it, therefore, the word can hardly be applicable to any "agreement" between the state and the corporation. If anything, there is a state grant of privileges and powers to the corporation—and indeed it was a "grant" to which Chief Justice Marshall applied the protection of the Constitution in the Dartmouth College case.

Nor is there, in the common sense of the term, a "contract" between the incorporators or stockholders among themselves. There is a consensual relationship; by becoming an incorporator or buying stock, there is an intended acceptance of the arrangements outlined in the incorporation papers. It is perhaps not unduly stretching the commercial terminology to call this a "contract" though it is clearly a specialized variety. Certainly, for example as it will appear in these materials, preferred shareholders have agreed rights over against common shareholders to which both are held.

The so-called "contract" between a corporation and its shareholders is rather more hazy. In a generic sense, the relationship undoubtedly exists, just as there is a relationship which can be classified as "contractual" between a trustee and the beneficiary. The chief terms of the relationship arise quite as much from duties imposed by law on those managing the corporation in favor of the stockholders, as they do from any words appearing in statute or charter.

Probably clearer thinking is promoted by regarding the corporate arrangement as falling in the generic category of "contract" and thereafter regarding the arrangement as *sui generis*. But, with this distinct reservation, since the word "contract" is classic, it may continue to be used.

The "contract" is formal and can be made only in certain ways prescribed by the state, through its general incorporation acts. There are, it is true, a few ancient historical survivals of corporations by prescription: for instance, a Catholic bishopric, whose historical origin is lost in antiquity. Aside from these, the corporate arrangement must be made in a particular manner, and must be sanctified by the state in a particular manner—the detail differs from state to state according to the local statutes.

1. THE FUNCTION OF THE STATE IN THE CORPORATE CONTRACT

NOTE

MODIFICATION OF THE CORPORATE CONTRACT

A corporate charter when granted by the state falls under the constitutional protection against impairment of contract under the decision in the Dartmouth College case. Chief Justice Marshall threw out the suggestion that this undesirable state of affairs could be avoided if incorporation acts "reserved to the state" the right to "alter, amend and repeal" such charters, and from then on every state in fact did reserve such power by appropriate clauses in special or general incorporation acts. Marshall was, of course, endeavoring to protect the state.

But, as charters developed from legislative grants to permissive agreements, power to alter, amend or repeal changed its quality.

Undeniably the reserved power of alteration was retained by the state for all purposes; the legislature, for example, could pass an act striking out some of the broad powers which incorporators include in their charters under permissive acts.

But the rule does not necessarily work the other way around. A state, acting under this reserved power, may, by further legislative act, authorize the incorporators to include new and greater powers, or to change the arrangement they set up. If all parties in interest unanimously exercise the new permission, no question is raised. But if the state offers these new and larger permissions—which perhaps fundamentally change the nature of the relationship between stockholders—to be availed of by a majority vote, the effect is to hand over the power to "alter, amend or repeal" to a group of private persons who will exercise that power, not to effectuate some policy of the state, but to improve their own business position—possibly at the expense of the minority.

It may fairly be asked how far, under the reserved power, a state can do this. If done to effectuate state policy—say to increase production, or provide employment, plainly there is solid argument for the proposition. But this introduces another set of considerations.

Change in a corporate charter may be for the purpose of increasing the scope or efficiency of the business. Or it may be merely for the purpose of shifting property rights from one class of stockholders to another—the only business interest visible being the desire of the controlling class to take unto themselves a larger share of the profits and income, without materially assisting the enterprise as an enterprise, and certainly without the slightest thought of forwarding any policy of the state.

As will be seen, the statutory rules are broad enough to allow almost anything to be done. If there is restraint, it comes from outside—from the common law; from the fact that persons who manage, or who control, certain corporate powers are held to certain standards of conduct towards other associates in the corporation who do not have the same power. In this sense, there is slowly developing a common law of corporations analogous to the common law which protects beneficiaries against certain forms of conduct by trustees. But the battle is endless: the contest between the standards of the common law and the conception that voting or management might makes corporate right.

TOMLINSON v. JESSUP.

Supreme Court of the United States, 1872. 82 U.S. 454, 21 L.Ed. 204.

Appeal from the Circuit Court for the District of South Carolina.

MR. JUSTICE FIELD delivered the opinion of the court.

The constitution of South Carolina, adopted in 1868, declares that the property of corporations then existing or thereafter created, shall be subject to taxation, except in certain cases, not material to the present inquiry. The subsequent legislation of the State carried out this requirement and provided for the taxation of the property of railroad companies; and the question presented is, whether the act of December, 1855, to amend the charter of the Northeastern Railroad Company, exempted the property of that company from such taxation. The company was incorporated in 1851, and at that time a general law of the State was in existence, passed in 1841, which enacted that the charter of every corporation subsequently granted, and any renewal, amendment, or modification thereof, should be subject to amendment, alteration, or repeal by legislative authority, unless the act granting the charter or the renewal, amendment, or modification, in express terms excepted it from the operation of that law. The provisions of that law, therefore, constituted the condition upon which every charter of a corporation subsequently granted was held, and upon which every amendment or modification was made. They were as operative and as much a part of the charter and amendment, as if incorporated into them.

The act amending the charter of the Northeastern Railroad Company, passed in December, 1855, provided that the stock of the company, and the real estate it then owned, or might thereafter acquire, connected with or subservient to the works authorized by its charter, should be exempted from taxation during the continuance of

the charter. This act contained no clause excepting the amendment from the provisions of the general law of 1841. It was, therefore, itself subject to repeal by force of that law.

It is true that the charter of the company when accepted by the corporators constituted a contract between them and the State, and that the amendment, when accepted, formed a part of the contract from that date and was of the same obligatory character. And it may be equally true, as stated by counsel, that the exemption from taxation added greatly to the value of the stock of the company, and induced the plaintiff to purchase the shares held by him. But these considerations cannot be allowed any weight in determining the validity of the subsequent taxation. The power reserved to the State by the law of 1841 authorized any change in the contract as it originally existed, or as subsequently modified, or its entire revocation. The original corporators, or subsequent stockholders, took their interests with knowledge of the existence of this power, and of the possibility of its exercise at any time in the discretion of the legislature. The object of the reservation, and of similar reservations in other charters, is to prevent a grant of corporate rights and privileges in a form which will preclude legislative interference with their exercise if the public interest should at any time require such interference. It is a provision intended to preserve to the State control over its contract with the corporators, which without that provision would be irrepealable and protected from any measures affecting its obligation. * * *

The reservation affects the entire relation between the State and the corporation, and places under legislative control all rights, privileges, and immunities derived by its charter directly from the State. Rights acquired by third parties, and which have become vested under the charter, in the legitimate exercise of its powers, stand upon a different footing; but of such rights it is unnecessary to speak here. The State only asserts in the present case the power under the reservation to modify its own contract with the corporators; it does not contend for a power to revoke the contracts of the corporation with other parties, or to impair any vested rights thereby acquired.

Decree reversed, and the cause remanded with directions to
Dismiss the suit.

GREENWOOD v. UNION FREIGHT RAILWAY COMPANY.

Supreme Court of the United States, 1881. 105 U.S. 13, 26 L.Ed. 961.

Argued Dec. 8, 1881. Decided Mar. 13, 1882.

Appeal from the Circuit Court of the United States for the District of Massachusetts. The case is stated by the court. * * *

MR. JUSTICE MILLER delivered the opinion of the court.

The appellant, Greenwood, a citizen of the State of New York, brings his bill of complaint, in the Circuit Court for the District of Massachusetts, against the Union Freight Railroad Company, a corporation established by the laws of Massachusetts; against the Mar-

ginal Freight Railroad Company, likewise a Massachusetts corporation; against the City of Boston, its Mayor and Aldermen by name, and against the Directors of the Marginal Freight Railroad Company, all citizens of Massachusetts.

The Union Freight Railroad Company demurred to the bill, and the demurrer was sustained and the bill dismissed. It is this decree which we are called on to review on appeal taken by complainant.

The case made by the bill is that the Marginal Freight Railroad Company, which we shall hereafter call the Marginal Company, was organized under an Act of the Legislature of Massachusetts, of the date of April 26, 1867, to build and operate a railroad through various streets in the City of Boston, "With all the privileges and subject to all the duties, restrictions and liabilities set forth in the general laws which now are or may hereafter be in force, relating to street railway corporations, so far as they are applicable." The right of way of this company for part of its route lay over the line of a railway previously granted to the Commercial Freight Railroad Company, and the Marginal Company, by virtue of a provision in its charter, purchased and paid the Commercial Company for the joint use of its track, so far as it ran through the same streets. Afterwards, on May 6, 1872, the Legislature of Massachusetts incorporated, by an Act of that date, the Union Freight Railroad Company, which by virtue of its charter and the authority of the Board of Aldermen of Boston, was authorized to run its track through the same streets and over the same ground covered by the track of the Marginal Company, and to take possession of the track of that and any other street railroad company on payment of compensation. This latter Act also repealed the charter of the Marginal Company.

Sections four, six and seven of this Act constitute the foundation of complainant's grievance, because they are said to impair the obligation of the contract found in the charter of the Marginal Company and, as they are short, they are here given verbatim.

"Section 4. Said corporation may, within its authorized limits, and for the purposes of this Act, enter upon and use any part of the tracks of any other street railroad, and may suitably strengthen and improve such tracks; and if the corporations cannot agree upon the manner and conditions of such entry and use, or the compensation to be paid therefor, the same shall be determined in accordance with the provisions of the thirty-eighth section of chapter three hundred and eighty-one of the acts of the year eighteen hundred and seventy-one.

"Sec. 6. Said corporation shall, within four months from the passage of this Act, take the tracks, or any part thereof, of the Marginal Freight Railway Company, subject to the laws relating to the taking of land by railroad companies and the compensation to be made therefor.

"Sec. 7. Chapter one hundred and seventy of the Acts of the year eighteen hundred and sixty-seven, entitled an 'Act to Incorporate the Marginal Freight Railway Company,' and so much of chapter four hundred and sixty-one of the Acts of the year eighteen hundred

and sixty-nine as relates to said Marginal Freight Railway Company, are hereby repealed."

The bill avers that the Union Freight Railroad Company has been organized, and is about to proceed in such a manner under this Act that the Marginal Company will be utterly destroyed, and its several contracts, franchises, rights, easements and properties will be impaired and destroyed, and the stock of complainant in said company will be destroyed and made valueless, and he will sustain irreparable damage and mischief.

Complainant then alleges that he had requested and urged the directors of the Marginal Company to take steps to assert the rights and franchises of the company against what he believes to be unconstitutional legislation, and that they had declined and refused to do so. He also sets out a vote or resolution of said directors, in which they respond to his demand by saying that the assertion of the rights of the corporation in the state courts is accompanied with so many embarrassments that they decline to attempt it. The prayer of the bill is for an injunction against all the defendants to prevent these acts so injurious to the rights of the Marginal Freight Railroad Company. * * *

As none of the defendants are charged with a purpose to exercise any power or to perform any acts not authorized by the terms of the Act of May 6, 1872, the remaining question to be decided is, whether the features of that Act to which complainant objects in his bill are beyond the power of the Legislature of Massachusetts, or are forbidden by anything in the Constitution of the United States.

These exercises of power in the statute complained of are divisible into two:

1. The repeal of the charter of the Marginal Company.
2. The authority vested in the Union Company to take its track for the use of the latter Company.

It is the argument of counsel, pressed upon us with such vigor, that the two taken together constitute a transfer of the property of the one corporation to the other, and with it all the corporate franchises, rights and powers belonging to the elder corporation.

We are not insensible to the force of the argument as thus stated; and we think it must be conceded that, according to the unvarying decisions of this court, the unconditional repeal of the charter of the Marginal Company is void under the Constitution of the United States, as impairing the obligation of the contract made by the acceptance of the charter between the corporators of that company and the State, unless it is made valid by that provision of the General Statutes of Massachusetts, called the reservation clause, concerning Acts of incorporation; or unless it falls within some enactment covered by that part of its own charter, which makes it "subject to all the duties, restrictions and liabilities set forth in the general laws, which now are or may hereafter be in force, relating to street railway corporations, so far as they may be applicable."

The first of these reservations of legislative power over corporations is found in section 41 of chapter 68 of the General Statutes of

Massachusetts, in the following language: "Every Act of incorporation passed after the eleventh day of March, in the year one thousand eight hundred and thirty-one, shall be subject to amendment, alteration or repeal at the pleasure of the Legislature."

It would be difficult to supply language more comprehensive or expressive than this.

Such an Act may be amended; that is, it may be changed by additions to its terms or by qualifications of the same. It may be altered by the same power, and it may be repealed. What is it may be repealed? It is the Act of incorporation. It is this organic law on which the corporate existence of the company depends which may be repealed, so that it shall cease to be a law; or the Legislature may adopt the milder course of amending the law in matters which need amendment, or altering it when it needs substantial change. All this may be done at the pleasure of the Legislature. That body need give no reason for its action in the matter. The validity of such action does not depend on the necessity for it, or on the soundness of the reasons which prompted it. This expression "the pleasure of the Legislature," is significant and is not found in many of the similar statutes in other states.

This statute having been the settled law of Massachusetts and representing her policy on an important subject for nearly fifty years before the incorporation of the Marginal Company, we cannot doubt the authority of the Legislature of Massachusetts to repeal that charter. Nor is this seriously questioned by counsel for appellant; and it may, therefore, be assumed that if the repealing clause of the Act of May 6, 1872, stood alone, its validity must be conceded. Crease v. Babcock, 23 Pick. (Mass.) 334, 34 Am.Dec. 61; Erie & N. E. R. Co. v. Casey, 26 Pa. 287; Pennsylvania College Cases, 13 Wall. 190, 20 L.Ed. 550; 2 Kent.Com. 306. * * *

If the essence of the grant of the charter be to operate a railroad, and to use the streets of the city for that purpose, it can no longer so use the streets of the city, and no longer exercise the franchise of running a railroad in the city. In short, whatever power is dependent solely upon the grant of the charter, and which could not be exercised by unincorporated private persons under the general laws of the State, is abrogated by the repeal of the law which granted these special rights.

Personal and real property acquired by the corporation during its lawful existence, rights of contract, or choses in action so acquired, and which do not, in their nature, depend upon the general powers conferred by the charter, are not destroyed by such a repeal, and the courts may, if the Legislature does not provide some special remedy, enforce such rights by the means within their power. The rights of the shareholders of such a corporation, to their interest in its property, are not annihilated by such a repeal, and there must remain in the courts the power to protect those rights.

And while we are conscious that no definition, at once comprehensive and satisfactory can be here laid down of what those rights and powers are that remain to the stockholders and creditors of such

a corporation after the Act of repeal, we are of opinion that the foregoing observations are sufficient for the case before us. * * *

It results from this view of the subject that whatever right remained in the Marginal Company to its rolling stock, its horses, its harness, its stables, the debts due to it, and the funds on hand, if any, it no longer had the right to run its cars through the streets or any of the streets of Boston. It no longer had the right to cumber these streets with a railroad track which it could not use, for these belonged by law to no person of right, and were vested in defendants only by virtue of the repealed charter.

It was, therefore, in the power of the Massachusetts Legislature to grant to another corporation, as it did, the authority to operate a street railroad through the same streets and over the same ground previously occupied by the Marginal Company. Whether this action was oppressive or unjust in view of the public good, or whether the Legislature was governed by sufficient reason in thus repealing the charter of one company and in chartering another at the same time to perform as part of its functions the duties required of the first, is not, as we have seen, a judicial question in this case. * * *

Nor are we satisfied of the soundness of the argument of counsel, that the clause in the Marginal Company's charter, which declares it to be subject to the restrictions and liabilities contained in the general laws relating to street railways, withdraws it from the operation of the 41st section of chapter 68 of the general laws of the State. The latter clause declares all Acts of incorporation subject to its provisions. This subjection is not impaired by the fact that a particular corporation is made by its charter subject to other laws also of a general character.

We are of opinion that the question of the repeal of the charter of the Marginal Company is to be decided by the construction of the general statute, whose effect and history we have discussed.

These considerations require the affirmance of the decree of the Circuit Court sustaining the demurrer to appellant's bill; and it is so ordered.

LOOKER v. MAYNARD ex rel. DUSENBURY.

Supreme Court of the United States, 1900. 179 U.S. 46, 21 S.Ct. 21.

In Error to the Supreme Court of the State of Michigan to review a decision sustaining the constitutionality of a statute permitting stockholders to cumulate their votes for directors. Affirmed.

MR. JUSTICE GRAY, after stating the case, delivered the opinion of the court:

The single question in this case is whether a power, reserved by the Constitution of a state to its legislature, to alter, amend, or repeal future acts of incorporation, authorizes the legislature, in order (as declared in the title of the statute of Michigan now in question) "to secure the minority of stockholders, in corporations organized under general laws, the power of electing a representative membership in

boards of directors," to permit each stockholder to cumulate his votes upon any one or more candidates for directors.

By the decision in the leading case of Dartmouth College v. Woodward, 4 Wheat. 518, 4 L.Ed. 629, it was established that a charter from the state to a private corporation created a contract within the meaning of the clause in the Constitution of the United States forbidding any state to pass any law impairing the obligation of contracts; and consequently that a statute of the state of New Hampshire, increasing the number of the trustees of Dartmouth College as fixed by its charter, and providing for the appointment of a majority of the trustees by the executive government of New Hampshire, instead of by the board of trustees as the charter provided, was unconstitutional and void.

Mr. Justice Story, in his concurring opinion in that case, after declaring that in his judgment it was "perfectly clear that any act of a legislature which takes away any powers or franchises vested by its charter in a private corporation, or its corporate officers, or which restrains or controls the legitimate exercise of them, or transfers them to other persons, without its assent, is a violation of the obligations of that charter," took occasion to add: "If the legislature mean to claim such an authority, it must be reserved in the grant." 4 Wheat. 712, 4 L.Ed. 677.

After that decision, many a state of the Union, in order to secure to its legislature the exercise of a fuller parliamentary or legislative power over corporations than would otherwise exist, inserted, either in its statutes or in its Constitution, a provision that charters thenceforth granted should be subject to alteration, amendment, or repeal at the pleasure of the legislature. See Greenwood v. Union Freight R. Co., 105 U.S. 13, 20, 21, 26 L.Ed. 961, 965. The effect of such a provision, whether contained in an original act of incorporation, or in a constitution or general law subject to which a charter is accepted, is, at the least, to reserve to the legislature the power to make any alteration or amendment of a charter subject to it, which will not defeat or substantially impair the object of the grant, or any right vested under the grant, and which the legislature may deem necessary to carry into effect the purpose of the grant, or to protect the rights of the public or of the corporation, its stockholders or creditors, or to promote the due administration of its affairs. Sherman v. Smith, 1 Black, 587, 17 L.Ed. 163; Miller v. New York, 15 Wall. 478, 21 L.Ed. 98; Holyoke Water Power Co. v. Lyman, 15 Wall. 500, 21 L.Ed. 133; Sinking Fund Cases, 99 U.S. 700, 720, 721, sub nom. Union P. R. Co. v. United States, 25 L.Ed. 496, 502; Close v. Glenwood Cemetery, 107 U.S. 466, 27 L.Ed. 408, 2 S.Ct. 267; Spring Valley Waterworks Co. v. Schottler, 110 U.S. 347, 28 L.Ed. 173, 4 S.Ct. 48; New York & N. E. R. Co. v. Bristol, 151 U.S. 556, 38 L.Ed. 269, 14 S.Ct. 437.

As illustrations of the right of the legislature, exercising such a reserved power, to alter for the future the liability of stockholders to creditors of the corporation, or the mode of computing the votes of stockholders for directors, it will be sufficient to state two of the cases just cited. * * *

Remembering that the Dartmouth College Case (which was the cause of the general introduction into the legislation of the several states of a provision reserving the power to alter, amend, or repeal acts of incorporation) concerned the right of a legislature to make a change in the number and mode of appointment of the trustees or managers of a corporation, we cannot assent to the theory that an express reservation of the general power does not secure to the legislature the right to exercise it in this respect.

Judgment affirmed.

STOCKHOLDERS OF THE PEOPLES BANKING COMPANY v. STERLING, RECEIVER.

Supreme Court of the United States, 1937. 300 U.S. 175, 57 S.Ct. 386.

MR. JUSTICE CARDOZO delivered the opinion of the Court.

* * * The Constitution of Maryland provides that "the General Assembly shall grant no charter for Banking purposes * * * except upon the condition that the Stockholders shall be liable to the amount of their respective share or shares of stock in such Banking Institution, for all its debts and liabilities upon note, bill or otherwise." Maryland Constitution, 1867, Article III, § 39. This provision was effective without more to impose a substantive liability upon stockholders in banks. Ghingher v. Bachtell, supra, pp. 688, 690. On the other hand, it did not take from the legislature the power to implement the liability with statutory remedies, nor in the absence of such statutes did it take that power from the courts. Ghingher v. Bachtell, supra. In January, 1910, when the Smithsburg bank was organized, the only applicable statute was Chapter 206 of the Acts of 1870. The Act shows by its title that it is one "to create State Banking Institutions to enable the several Banks in this State—State and National—to avail of the provisions thereof." It provides (§ 11) that "the continuance of the said several corporations shall be on the condition that the stockholders and directors of each of said corporations shall be liable to the amount of their respective share or shares of stock in such corporation, for all its debts and liabilities upon note, bill or otherwise, and upon this further condition, that this Act and every part of it may be altered from time to time, or repealed by the Legislature." The Maryland courts have held in a series of decisions that the liability thus recognized was not enforcible by the bank itself in the event of its insolvency, or by a liquidator or receiver suing in its behalf. * * The right of action was no part of the assets of the insolvent corporation. The meaning of the statute was thought to be that every creditor of the corporation in assuming that relation acquired for his individual use, and not as a class representative, a supplemental right of action against the holders of the shares. To rationalize this right of action, it was said to rest upon an implied contract between the creditor on the one side and on the other the holders of the shares at the creation of the debt. Ghingher v. Bachtell, supra. Contract being the basis of the statutory remedy, the courts deduced the consequence that the liability did not extend to stockholders who became such after

the debt was in existence. For the same reason any stockholder was free to reduce his liability by the use of set-offs or counterclaims available at the time of suit against the primary obligor. Ghingher v. Bachtell, supra, p. 694; Cahill v. Original Big Gun Ass'n, 94 Md. 353, 50 A. 1044.

In June, 1910, less than five months after the incorporation of this bank, a statute was enacted abrogating the remedy under the then existing statute and substituting another. Acts of 1910, c. 219; Maryland Code, Article II, § 72 "Stockholders of every bank and trust company shall be held individually responsible, equally and ratably, and not one for another, for all contracts, debts and engagements of every such corporation, to the extent of the amount of their stock therein, at the par value thereof, in addition to the amount invested in such stock * * * and the liability of such stockholders shall be an asset of the corporation for the benefit ratably of all the depositors and creditors of any such corporation, if necessary to pay the debts of such corporation, and shall be enforceable only by appropriate proceedings by a receiver, assignee or trustee of such corporation acting under the orders of a court of competent jurisdiction." A like remedy had previously been created against stockholders in trust companies. Acts of 1904, c. 101; Acts of 1908, c. 153. Through these amendatory acts, the cause of action formerly enforcible by the creditors separately, each suing for himself, became enforcible by the receiver as the representative of all. As a consequence of the new procedure, the assessment was to be laid upon all the holders of shares at the time of liquidation without reference to their relation to the bank at the creation of the debts, though stockholders dropping out sooner might escape a liability which under the earlier law would have clung to them indefinitely. Moreover, offsets and counterclaims were no longer to be available to reduce the several assessments and thus establish inequality. Stockholders when sued by the receiver would contribute to the fund ratably, and then prove their claims against the bank in the same way as other creditors. Such in outline is the effect of the statutory changes as the highest court of Maryland has defined them in this very case.

Do changes of that order impair the obligation of a contract between the corporation and the stockholders in contravention of the provisions of the Constitution of the United States?

The answer must be "no," and this for two reasons, first, because the changes are directed to the implementing remedies rather than the substantive liability, and second, because a change of substantive liability was made permissible by the reservation of a power of alteration or repeal.

(1) The obligation laid upon the shareholders by the Maryland Constitution, though susceptible of legislative and judicial regulation in respect of the mode of its enforcement, was a substantive liability to which every stockholder subjected himself upon the acquisition of his stock. The legislature did not exhaust the measure of that constitutional liability by the creation of a particular remedial device. The remedy adopted was interpreted judicially as having in view a

suit by a creditor against the particular group of stockholders who had undertaken by implication to answer for his debt. This does not mean that a different form of remedy, for example a suit by a receiver, would have been a departure from the Constitution, if the statute had prescribed that method of enforcement. The broad but indefinite words of the constitutional command gave permission to the legislature to establish any remedies reasonably appropriate to the general end in view. Cf. Whitman v. Oxford National Bank, 176 U.S. 559, 562, 20 S.Ct. 477, 478; Bernheimer v. Converse, 206 U.S. 516, 529, 27 S.Ct. 755, 759. So, the broad but indefinite words of the legislation first adopted, the Act of 1870, gave freedom to the courts to develop through the process of construction a cause of action enforcible at the instance of a creditor without asserting in so doing that a different cause of action, enforcible through a receiver, would have been an inappropriate implement of the constitutional liability, in the event that the legislature or the courts had chosen to adopt it. Stockholders who became such while the first statute was in force were chargeable with notice that a new remedy might be adopted if the one first chosen was inadequate. They would have been chargeable with such notice though nothing had been said. They were chargeable, as it happens, by the wording of the statute, the charter being granted upon the condition that the Act or any part of it might be altered or repealed.

The remedy first established was found to be unworkable. Ghingher v. Bachtell, supra, at p. 692; Murphy v. Wheatley, 102 Md. 501, 515, 63 A 62. Still acting within the limits of the constitutional command, the legislature of Maryland announced another remedy, less unwieldy and confusing. In the view of the state court, the substantive liability as the Constitution had created it was the same under the new procedure as it has been from the beginning. Ghingher v. Bachtell, supra. The court was far from holding that the statute had enlarged it. What had happened was merely this, that another remedy had been established to implement a liability created long ago. * * We cannot see in this an attempt to lay upon the stockholders by force of later legislation a new and different burden from that accepted at the outset. Nor would it help the appellants anything to assume in their behalf that the Constitution of the State has been given a new meaning, if the new meaning is not due to the compulsion of a statute. Change by judicial construction of antecedent legislation does not impair a contract, at least in the forbidden sense, if it be granted *arguendo* that such a change can be discovered. * * * The new meaning, if there is any, is not ascribed to the Constitution because a later statute has said it must be done. The new meaning is the product of the independent judgment of a court. So the state court has told us, and the good faith of its declaration is not successfully impeached. Broad River Power Co. v. South Carolina, 281 U.S. 537, 540, 50 S.Ct. 401, 402. To changes thus wrought the Constitution of the United States does not offer an impediment.

(2) The result would not be different if the effect of the statutory amendments were to be viewed as an enlargement of the substantive liability for debts afterwards contracted, the enlargement being ap-

plicable to stockholders without exception, present as well as future. The charter was accepted subject to the condition that the personal liability then prescribed by statute should be subject thereafter to repeal or alteration. This court has held that when such a condition attaches to a charter, there is no unconstitutional change of the obligation of a contract by a subsequent enlargement of the liability of stockholders as to debts afterwards contracted, though the shares so affected were acquired before the change was made. * * * Stockholders who subscribe to stock subject to such a condition assume the risk that their relation to the corporation may be altered to their prejudice. Nor is their position any stronger because the new liability is heavier (if so it be assumed to be) than that imposed upon them directly by the Constitution of the State. The constitutional liability is not a maximum, but a minimum, and the legislature does not transcend the bounds of legislative power by increasing it thereafter. * * *

McNULTY v. W. & J. SLOANE.

Supreme Court of New York, Special Term, 1945. 184 Misc. 835, 54 N.Y.S.2d 253.

SHIENTAG, JUSTICE. * * * "Vested right" was indeed a term susceptible of many shades of meaning, a term which had not been clearly defined in the cases. Whenever the court was of the opinion that certain rights of stockholders could not be interfered with, they characterized those rights as "vested." The doctrine of vested rights was found to be inadequate as a general test.

2. RIGHTS OF MODIFICATION OF THE CORPORATE CONTRACT RESERVED TO THE DIRECTORS OR TO A MAJORITY OF THE STOCKHOLDERS

NOTE

MODIFICATION OF CHARTERS WHERE THE CHIEF EFFECT IS TO CHANGE PROPERTY RIGHTS AS BETWEEN ASSOCIATES

It is the belief of the editors that there is a clear distinction between (a) modification of a corporate charter by corporate action for the purpose of giving additional ease or representative quality to management or of enlarging the scope of its business activities, and (b) modification merely for the purpose of changing property rights within the corporation.

The first class of changes are designed primarily to aid the enterprise as a whole, and the benefits presumably flow to all concerned. Here presumption may safely be indulged that the changes sought benefit the business.

But in the second class of cases—modification of property or other rights as between the one group of associates and another—, in strict logic the presumption is not warranted. There is a wide difference, for example, between an amendment to a corporate charter authorizing it to enter a new form of business or changing its voting rights so that there shall be cumulative voting representing minorities as well as majorities; and a modification which cuts off the rights of a cumulative preferred stock to receive its accrued cumulative dividends, so that the common stock can tap the profit stream for its own advantage instead of paying up arrearages. There is not necessarily a presumption, in this latter case,

as it seems to the editors, that a business interest of the corporation is being served. And, clearly, there is no state policy involved. Permission to change the charter in this respect would seem not to be absolute and beyond control of the courts, but to be merely a power given by the state to the corporation, exercisable only under general common law restraint that the management or the majority (as the case may be) must use it for the general benefit, and not to advantage one group of shareholders against another.

Manifestly, special circumstances may exist when the sacrifice of rights by one group is needed or useful to preserve or forward the interests of the entire corporation—as where sacrificing the rights of cumulative preferred stockholders to arrears of dividends may be needed in order to permit the flotation of an issue of common stock which will save the corporation from financial embarrassment. But it would seem that the burden rests on the group proposing the change to show that a general corporate interest was involved—and not the desire of one group to eliminate for its own benefit rights previously given.

NEW YORK STOCK CORPORATION LAW

§ 35. *Change of purposes, powers or provisions, or number of directors or location of office.* A stock corporation may effect one or more of the following changes:

(A) To extend, limit, or otherwise change its purposes and powers or other provisions of its certificate of incorporation;

(B) To increase or reduce the number of its directors, or to provide that the number of directors shall be not less than a stated minimum nor more than a stated maximum; but in neither case below the minimum number prescribed by law;

(C) To change the location of its office, if it is not a moneyed corporation:

By filing a certificate which shall be entitled and endorsed "Certificate of (stating the nature of the change to be accomplished) of (name of corporation) pursuant to section thirty-five of the stock corporation law" and state:

1. The name of the corporation, and, if it has been changed, the name under which it was originally incorporated;

2. The date of filing of the certificate of incorporation in each state office where filed, or, if the corporation is created by a special law and has no certificate of incorporation, the chapter number and year of passage of such law;

3. The purposes, powers or provisions, if any, to be amended or eliminated, and the purposes, powers or provisions, if any, to be added or substituted;

4. If the number of directors is to be increased or reduced, the number previously authorized and the number as increased or reduced;

5. If the location of the office of the corporation is to be changed, the city, town or village and the county in which its office is located, and the city, town or village and the county to which it is to be removed.

Provided, (a) that no change shall be made under this section which can be made under any other section of this chapter or under any other corporate law; (b) that no corporation organized under

a general law shall amend its certificate of incorporation hereunder to embody therein any purpose, power or provision which would not be authorized if its original certificate including such additional purposes, powers or provisions were offered for filing at the time the certificate under this section is so offered, and (c) that no corporation organized by or under any special law shall change the general character of its business as authorized by such special law.

The number of directors may be increased under this section, notwithstanding the maximum number prescribed by law.

Such certificate shall be either:

a. Subscribed and acknowledged by every subscriber of the certificate of incorporation and every subscriber to stock, and shall have annexed an affidavit by one of the subscribers of the certificate of incorporation to the effect that no stock has been issued and that the persons who have executed the certificate constitute all of the subscribers of the certificate of incorporation and all of the subscribers to stock; or

b. Subscribed and acknowledged, in person or by proxy, by the holders of record of all of the outstanding shares of the corporation entitled to vote thereon, and shall have annexed an affidavit by the secretary or an assistant secretary of the corporation that the persons who have executed the certificate, in person or by proxy, constitute the holders of record of all of the outstanding shares of the corporation entitled to vote thereon; or

c. Subscribed and acknowledged by the president or a vice-president and the secretary or an assistant secretary, who shall make and annex an affidavit stating that they have been authorized to execute and file such certificate by the votes, cast in person or by proxy, of the holders of record of two-thirds of the outstanding shares of the corporation entitled to vote thereon, if the change be made under subdivision (A) of this section, or of the holders of record of a majority of such shares if the change be made under subdivision (B) or (C) of this section, and that such votes were cast at a stockholders' meeting held on a date specified upon notice pursuant to section forty-five of the stock corporation law.

No such certificate shall be filed by a banking corporation unless the approval of the superintendent of banks, nor by an insurance corporation unless the approval of the superintendent of insurance, be endorsed thereon.

Such certificate shall be filed in each state office in which its certificate of incorporation is filed, and in every case a certified copy thereof or a duplicate original shall be filed in the office of the clerk of the county in which the office of the corporation is located and if such certificate changes the location of the office of the corporation, it shall be filed in the office of the clerk of the county to which its office is to be removed. If the corporation was created by a special law and has no certificate of incorporation, such certificate shall be filed in the office of the superintendent of banks if a banking corporation, in the office of the superintendent of insurance if an insurance corporation, and in the office of the secretary of state, if it is neither a banking or insurance corporation.

(a) Amendments Affecting the Extent and Operation of the Enterprise

DURFEE v. OLD COLONY & FALL RIVER RAILROAD COMPANY.

Supreme Judicial Court of Massachusetts, 1862. 5 Allen (87 Mass.) 230.

Bill in equity brought by the plaintiff, a minor, by John S. Brayton, his guardian, to restrain the defendants, a railroad corporation established under the law of this commonwealth, and the directors thereof, from proceeding to act under St.1861, c. 156, authorizing them to extend their railroad to the line of the State of Rhode Island, or under St.1862, c. 149, authorizing their union with the Newport and Fall River Railroad Company.

The case was heard upon the bill, answer and demurrers, before the chief justice, and reserved for the determination of the whole court. The arguments upon the questions of jurisdiction and pleading are omitted.

BIGELOW, C. J. We do not deem it necessary to consider the questions raised by the demurrer to the bill, nor to discuss the nature or extent of the jurisdiction of this court in equity over corporations, at the suit of one or more of their stockholders, in cases where there has been an excess or abuse of the power or authority conferred by legislative grants. In the view which we have taken of the merits of the case, these questions become immaterial.

The case for the plaintiff mainly rests on the single proposition of law, that a corporation established by the legislature of this commonwealth, by acts which, under St.1830, c. 81, are subject to alteration, amendment or repeal, at the pleasure of the legislature, cannot engage in any new enterprise or enter upon any new undertaking, in addition to that contemplated by and embraced in the original charter of the company, against the consent of any one of its stockholders, although such new enterprise or undertaking is of the same kind with that for which the corporation was originally established, and is authorized, sanctioned and adopted by an express legislative grant, and by a vote of the majority of the stockholders duly ascertained according to law. * * *

We suppose it may be stated as an indisputable proposition, that every person who becomes a member of a corporation aggregate by purchasing and holding shares agrees by necessary implication that he will be bound by all acts and proceedings, within the scope of the powers and authority conferred by the majority of the corporation, duly taken and ascertained according to law. This is the unavoidable result of the fundamental principle that the majority of the stockholders can regulate and control the lawful exercise of the powers conferred on a corporation by its charter. A holder of shares in an incorporated body, so far as his individual rights and interests may be involved in the doings of the corporation, acting within the legitimate sphere of its corporate power, has no other legal control over them than

that which he can exercise by his single vote in the meetings of the company. To this extent he has parted with his personal right or privilege to regulate the disposition of that portion of his property which he has invested in the capital stock of the corporation, and surrendered it to the will of a majority of his fellow corporators. The jus disponendi is vested in them so long as they keep within the line of the general purpose and object for which the corporation was established, although their action may be against the will of a minority, however large. It cannot, therefore, be justly said that the contract, express or implied, between the corporation and the stockholders is infringed or impaired by any act or proceeding of the former which is authorized by a majority, and which comes within the terms of the original statute creating and establishing their franchise, and conferring on them capacity to exercise control over the rights and property of their members. On the contrary, the fair and reasonable implication resulting from the legal relation of the stockholder and the corporation is, that the majority may do any act either coming within the scope of the corporate authority, or which is consistent with the terms and conditions of the original charter, without and even against the consent of an individual member.

Such being the nature of the contract which subsists between the corporation and each of its members, we have only to inquire, in the present case, whether it has been in any respect violated by the present defendants. The answer to this inquiry will be found in the interpretation which is put on that clause of the general laws of this commonwealth already cited, by which a right is reserved to the legislature to amend, alter or repeal any act of incorporation which has been established by its authority since the enactment of that provision in St.1830. Whatever may be the extent of the authority which is thereby retained by the legislature to modify or change the charters of corporations without or against their consent, there would seem to be no reason to doubt that, with the concurrence of the corporation manifested in the mode pointed out by law, the legislature may make any alteration in or addition to the power and authority conferred by the original act of incorporation, and not foreign to the purposes and objects for which it was enacted, and which it was designed to accomplish, which may seem to be expedient or necessary. No breach of contract would be thereby occasioned. Such action would be in precise accordance with the terms on which the grant of the franchise was made. In creating a corporation, no contract is made by the legislature with the individual members or stockholders, any further than they are represented by the artificial body which the act of incorporation calls into being. They have no other rights except those which exist or grow out of the constitution of the body corporate of which they are members. To this only can we look, in order to ascertain whether there has been any breach of contract or violation of chartered rights. It constitutes, of itself, the contract by which the rights of all parties are to be governed. When, therefore, it is expressly provided between the legislature on the one hand and the corporation on the other, as part of the original contract of incorporation, that the former may change or modify or abrogate

it or any portion of it, it cannot be said that any contract is broken or infringed when the power thus reserved is exercised with the consent of the artificial body of whose original creation and existence such reservation formed an essential part. The stockholder cannot say that he became a member of the corporation on the faith of an agreement made by the legislature with the corporation, that the original act of incorporation should undergo no change except with his assent. * * * The real contract into which the stockholder enters with the corporation is, that he agrees to become a member of an artificial body which is created and has its existence by virtue of a contract with the legislature, which may be amended or changed with the consent of the company, ascertained and declared in the mode pointed out by law. Having, by virtue of the relation which subsists between himself and the corporation as a holder of shares, assented to the terms of the original act of incorporation, he cannot be heard to say that he will not be bound by a vote of the majority of the stockholders accepting an amendment or alterations of the charter made in pursuance of an express authority reserved to the legislature, and which by such acceptance has become binding on the corporation. Such we understand to be the result of the adjudicated cases. In Crease v. Babcock, 23 Pick. (Mass.) 342, 34 Am.Dec. 61, it was expressly decided that corporators, by accepting a charter, directly agree to adopt the provision reserving to the legislature the right to amend, alter or repeal the act of incorporation as a constituent part of their contract; and it has often been decided, under similar provisions in the statutes of other states, that amendments or changes, either abridging the corporate authority or enlarging and extending it so as to embrace new enterprises and to incur additional burdens and liabilities, when duly adopted by the corporation, are valid and binding on a dissenting minority, as well as on those corporators by whose votes the amending act has been accepted and approved. Buffalo & N. Y. C. Railroad Co. v. Dudley, 14 N.Y. 336, 348, 354; Northern Railroad v. Miller, 10 Barb. (N.Y.) 282; Southern Bay Meadow Dam Co. v. Gray, 30 Me. 547; Oldtown & L. Railroad Co. v. Veazie, 39 Me. 580; Banet v. Alton & S. Railroad Co., 13 Ill. 504.

It was urged, as a grave objection against the doctrine above stated, that it puts the minority of the stockholders of a corporation entirely within the control of the legislature and a majority of the stockholders, and that there would be no limit or restraint placed on the exercise of the power, so that corporations might be diverted to purposes and objects wholly foreign to those for which they were originally established, and stockholders might be made to participate against their will in undertakings which they never contemplated and which they deemed inexpedient or ruinous. If this be so, it is a consequence of which no stockholder can reasonably complain, because it is a result which flows from the contract into which he has voluntarily entered. * * *

Bill dismissed.

ZABRISKIE v. HACKENSACK & NEW YORK RAILROAD COMPANY.

Court of Chancery of New Jersey, 1867. 18 N.J.Eq. 178, 90 Am.Dec. 617.

THE CHANCELLOR. The Hackensack and New York Railroad Company was incorporated in 1856, with power to construct a railroad from Hackensack to the Paterson and Hudson River Railroad, with a capital stock of two hundred dollars, and with power to mortgage its road and lands, franchises and appurtenances, to the amount of fifty thousand dollars. Under this act, it laid out, located, and built a road five miles in length, terminating at Essex street, in Hackensack, within one mile of the court-house, as required by the charter. It borrowed thirty thousand dollars, for which it gave a mortgage upon the road and its equipment, franchises, and other property. By a supplement to this charter, passed March 12th, 1861, it was authorized to extend the road northwardly to Nanent, on the Erie railway, in the state of New York, a distance of about twelve miles, to increase the capital stock to any extent required, and to issue bonds to the amount of two hundred and fifty thousand dollars, which, in the words of the act, were "for the construction and equipment of the road to be constructed under this act, and to secure the payment of said bonds, the said company shall have power to mortgage the said road, with its franchises and chartered rights."

In 1861, the company extended its road under this supplement to a point on Passaic street, in the village of Hackensack, more than a mile from the court-house, the length of the extension being about a mile. After this, it executed a new mortgage upon the whole road, as extended, and its equipments, and its franchises and chartered rights, to secure the payment of ten thousand dollars. No new stock was issued for this extension.

The company has recently, under the supplement of 1861, laid out and located another extension for about a mile and a half north of the present terminus, reaching from Hackensack to New Bridge, and has made contracts for the construction of it, and has, by resolution, determined to make a new mortgage to cover the whole road, as it will be when finished to New Bridge, with its equipments and appurtenances, and the chartered rights and franchises of the company, to secure one hundred bonds of one thousand dollars each, for the purpose of paying off the two mortgages which are now on the road; for relaying with new rails and ties the road first built, and furnishing it with the necessary equipment, which is now deficient for its business; and for constructing and equipping the extension to New Bridge.

The complainant is a stockholder in the company; and of nine hundred and thirty shares of capital stock issued, for one hundred dollars each, he owns three hundred and twenty-four. He applies for an injunction to restrain the defendants from constructing the extension to New Bridge, and from executing the mortgage proposed.

He opposes the extension, on the ground that it is a different enterprise from that for which his stock was taken, and the money paid, and that neither the directors, nor a majority of the stockholders, can compel him to embark his capital in any undertaking but the one for which it was subscribed and paid.

The extension to Nanent, authorized by the act of 1861, has never been submitted formally to the stockholders, nor has it in any way been approved of by them, or a majority of them, except by the assent given in the answer in this suit, to which the directors are made defendants, which is sworn to by the directors, individually, who own together five hundred and seventeen shares of the capital stock. But of this, two hundred shares, held by one of them, Mr. Robert Rennie, is special stock, issued to him to build the Lodi Branch, which is leased to him during the existence of the company, and which he is to operate at his own expense and for his own profit, under an agreement that he shall pay as rent, the dividends that may be declared on these two hundred shares; and under another agreement. endorsed on the certificate of stock issued for these shares, that they are to be entitled to no dividends beyond the rent of the Lodi Branch, or in other words, that he is to pay no rent, and this stock is to receive no dividends. Under these circumstances, this stock can receive no benefit from the extension if it is profitable, nor sustain any loss from it if it is ruinous. And it would seem that if the consent of a majority of the shareholders was necessary to the new enterprise of the extension, that the assent of the other three hundred and seventeen shares held by the directors, not being a majority of the whole stock held by the complainant, who dissents, is not the consent of the majority of the stockholders. And, if it is necessary to obtain the consent of a majority to make the extension authorized by the supplement of 1861, that consent does not appear in the cause as now presented.

The extension authorized by the act of 1861, is a radical change in the object of this corporation; it is an enterprise entirely different from that in the charter. That was to construct and operate a railroad from Hackensack to the Paterson railroad, at Boiling Spring, an easy and almost direct route to New York; it was from a thriving village, the county town of Bergen county, over a level country, and only five miles in length, as shown by the return of its location. The extension would be about twelve miles in length, through an uneven country, mostly, if not wholly, agricultural; with no village, except the very small one at New Bridge, on its route; and it runs into the state of New York some distance, and terminates at a point on that part of the Erie railway which the company have abandoned for regular traffic, and on which few trains are run. It is an entirely different enterprise.

The question here is, can this company, either with or without the consent of a majority in interest, of its stockholders, compel the complainant to embark capital subscribed for the first enterprise, in this new one, entirely different.

Since the Dartmouth College Case, in the Supreme Court of the United States, the doctrine has been considered firmly established,

and been confirmed by repeated decisions, both in that court and the state courts, that a charter, granted by the legislature to a corporation, is a contract between the state and the corporators, and that the state can pass no act to take away or impair any of the franchises or privileges granted by it. The company, or artificial person thus created, and its property, is subject to all general laws and police regulations made by the legislature after such grant, in the same manner as natural persons and their property are; provided they are not such as to take away or impair any of the franchises plainly granted by the charter. This doctrine did not prevent the legislature from conferring new privileges upon any corporation, to be accepted at its own election.

It is also settled, upon the principles of the common law, in this state, and most of the states of the Union, that when a number of persons associate themselves as partners, for a business and time specified in the agreement between them, or become members of a corporation for definite purposes and objects specified in their charter, which in such case is their contract, and for a time settled by it, that the objects and business of the partnership or corporation cannot be changed, or abandoned, or sold out, within the time specified, without the consent of all the partners or corporators; one partner or corporator, however small his interest, can prevent it. And this is so, although by law a majority in either case can control or manage the business against the will and interest of the minority, so long as it is within the scope of the partnership or charter.

This rule is founded on principle, the great principle of protecting every man and his property by contracts entered into, a guiding principle in all right legislation, and incorporated into the constitution of the United States, and of almost every state in the Union. And the rule is not changed because the new business or enterprise proposed is allowed by law, or has been made lawful since the association was formed. * * *

After the effect of the rule established in the Dartmouth College Case began to be felt in the states, it was found that by the numerous acts of incorporation, freely and perhaps necessarily granted, great inconveniences resulted, and that provisions incautiously inserted, too much restricted the power of future legislatures; and that the laws, which experience showed were necessary to govern corporations in the exercise of their powers, could not be passed. And the legislature of many states, by degrees and successively, adopted the practice of inserting in acts granting franchises, that they might alter, modify, or repeal the act; and also, by general law, provided that all acts of incorporation thereafter passed, should be subject to such alteration and repeal.

The provision is contained in the general act of this state, passed in 1846, (Nix.Dig. 152, § 6), that such charters should be subject to alteration, suspension, and repeal, in the discretion of the legislature. This and all similar special and general provisions were intended for the purpose specified; to give to the legislature the clear right, at their pleasure, to alter or repeal the acts of incorporation. The state, without this, could have done it with the assent of the corporators.

They could give them property; they could add to their powers or privileges. But they could not take away any power, privilege, or franchise, conferred by the act, nor compel them to exercise any new power or franchise conferred.

Besides this general law of the state, the charter of the defendants contains this provision, that "the legislature may, at any time, alter, modify, or repeal the same."

The object and purpose of these provisions are so plain, and so plainly expressed in the words, that it seems strange that any doubt could be raised concerning it. It was a reservation to the state, for the benefit of the public, to be exercised by the state only. The state was making what had been decided to be a contract, and it reserved the power of change, by altering, modifying, or repealing the contract. Neither the words nor the circumstances, nor apparent objects for which this provision was made, can, by any fair construction, extend it to giving a power to one part of the corporators as against the other, which they did not have before.

It was to void the rule in the Dartmouth College Case, not that in Natusch v. Irving [decided by Lord Eldon, in 1824], that the change was made. The words limit the power to that object.

On general principles, and the settled rules of construction, I would hold this to be the effect, and only effect, of the provision in the general act and in the charter of the defendants, without any hesitation, were it not for a series of decisions by most respectable courts, which hold that this provision obviates the effect of the rule in Natusch v. Irving and Kean v. Johnson, 9 N.J.Eq. 401, and enables a majority of the corporators in all charters subject to a like provision, to change, by legislative permission, and within certain limits, the object and purpose of the corporation. They hold that the contract between associate corporators, that they will confine their business to life insurance, is changed by legislative permission to engage in marine insurance, or a contract to join in constructing a railroad from New York to Newark, can be changed to one from New York to Elizabeth by legislative consent. The reasoning is founded on the fact that the subscription for the stock, which is the contract, was made as in this case under a charter which authorizes a road from the Paterson road to Hackensack, and authorizes the legislature to alter and modify the act. And from this they infer that it is a contract to join in building any road that the legislature may, by such alteration, authorize the company to build; and that such authority, or additional privilege, may be accepted by a majority of the corporators.

So far as the alteration is made by the legislature, in a way to be compulsory on the corporation, this is correct: as, if they should require the company to build a double track, or widen the draws in a bridge, or exact less fare or toll; these would be within the contract, or would be annexed to it as a condition, and every stockholder would take his stock subject to the contingency of such alteration.

But if the change in the act is simply offering the corporation the privilege of entering upon another and a different enterprise, it is not within the condition to the subscription. The only construction

to be given is, that the legislature may alter, not that the stockholders may, as between each other. The case of Natusch v. Irving was decided upon this very ground. The act of Parliament had given the company the power to embark in marine insurance, but the consent of all the parties was still held necessary. The plain object of the reservation in this case was to give the legislature, not a bare majority of the stockholders, power.

This view of the case is so clear upon principle that I feel constrained to be guided by it, although the weight of the decisions in other states is against it. * * *

There is no other alternative to the proposition, that while the power reserved authorizes the legislature, within certain limits, to make such alterations as they choose to impose, it gives no authority, when the legislature does not impose them, for the majority to adopt such alterations or enter upon such enterprises as are allowed by the legislature.

Again, the power of the legislature has its limits. It can repeal or suspend the charter; it can alter or modify it; it can take away the charter; but it cannot impose a new one, and oblige the stockholders to accept it. It can alter or modify the old one; but power to alter or modify anything can never be held to imply a power to substitute a thing entirely different. It is not the meaning of the words in their usually received sense. Power to alter a mansion-house would never be construed to mean a power to tear down all but the back kitchen and front piazza, and build one three times as large in its place. In anything altered, something must be preserved to keep up its identity; and a matter of the same kind, wholly or chiefly new, substituted for another, is not an alteration; it is a change.

In some cases there might be room for doubts, but in this case there can be no hesitation in saying that a railroad of seventeen miles from the Paterson road to Nanent, is a change and substitution of one work for another, and not an alteration of the road to Hackensack. They are substantially two different enterprises. * * *

The defendants must be restrained from extending the road beyond its present terminus at Passaic street, and from expending any money of the company to pay for any such extension, or from giving any mortgage for the cost of such extension. * * *

(b) *As to the Modification of Property or Contract Rights*

SALT LAKE AUTOMOBILE CO. v. KEITH–O'BRIEN CO.

Supreme Court of Utah, 1914. 45 Utah 218, 143 P. 1015.

FRICK, J. * * * The only question to be solved by us is whether, under our Constitution and statutes, a majority of the stockholders of a corporation may amend the articles of incorporation to authorize an issue of preferred stock, which shall take precedence in rights over prior issued preferred stock, and to divide the whole stock into classes, with such preferential rights. The Constitution of this state (article 12, § 1) reads as follows:

"Corporations may be formed under general laws, but shall not be created by special acts. All laws relating to corporations may be altered, amended or repealed by the Legislature, and all corporations doing business in this state may, as to such business, be regulated, limited or restrained by law."

The law in force at the time the company was organized, respecting the authority to amend the articles of incorporation and which is now in force, is found in Comp.Laws 1907, § 338, which, so far as material here, reads as follows:

"The articles of incorporation of any corporation now existing or that hereafter may be organized under the laws of this state may be amended in any respect conformable to the laws of this state by a vote representing at least a majority in amount of the outstanding capital stock thereof at a stockholders' meeting called for that purpose, as prescribed in section 339; * * * provided further, that the original purpose of the corporation shall not be altered or changed without the approval and consent of all the outstanding stock; provided further, that the adding to the purposes or object, or extending the power and business of the corporation, shall not be deemed a change of the original purpose of the corporation; * * * and, provided further, that the personal or individual liability of the holder of full paid capital stock for assessments or for the indebtedness or obligation of the corporation shall not be changed without the consent of all the stockholders."

The law conferring authority upon corporations to classify their capital stock, which was in force when the amendment in question was adopted, is found in Laws Utah 1913, p. 52, and reads as follows:

"The articles of incorporation may provide that the capital stock shall be divided into different kinds and classes, and define the rights and privileges that each kind and class of stock shall possess, and the power to vote may be confined by the articles to such kinds and classes of stock as may be designated therein. When not otherwise provided in the articles, at all meetings, each shareholder shall be entitled to one vote for each share of stock which he or she may have in his or her own right, or held by him or her in trust for others, *as shown by the books of the corporation,* and such votes may be given in person, or by an authorized agent, or by proxy."

The foregoing, with the exception of the eight italicized words, namely, "as shown by the books of the corporation," is found in Comp. Laws 1907 as section 335, and was in force when the company was organized, and with the exception of the eight words aforesaid has been in force ever since. It would seem, therefore, that not only is the Legislature by the Constitution authorized to amend all laws relating to corporations within the limits pointed out by this court in Garey v. St. Joe Mining Co., 32 Utah 497, 91 P. 369, 12 L.R.A.,N.S., 554, but the right to amend the articles of incorporation by the majority of the stockholders, with the exceptions stated in section 338, supra, is expressly given. That section is as much a part of the articles of incorporation as though it were specially referred to or set forth at large therein.

While counsel for appellant do not question the foregoing statement of the law, yet they contend that it has no application to the question before us, for the reason that the issuance of the preferred stock in question falls within one of the exceptions referred to in the Garey Case, supra, in that a fundamental or vested right is invaded, which, they contend, involves the question of the impairment of the obligations of contracts, which is prohibited by our own as well as by the federal Constitution. Counsel have cited cases in which it is held that although a corporation has power to classify its capital stock and to issue preferred stock at the time of its organization, yet, if a corporation issues only common stock when organized, it may not, unless the right to do so is reserved in the articles or is expressly given by some statute, thereafter issue preferred stock which has preferential rights over other preferred stock without the consent of all the stockholders. We do not question the soundness of those cases when limited to the circumstances on which they are based; but, in our judgment, they have no application under our statute. To that effect are practically all the authorities. In 3 Clark & Marshall, Private Corporations, § 630, the law is stated thus:

"A majority of the stockholders of a corporation clearly have the power to make any alterations or changes in the constitution of the corporation which are authorized by its charter, for this power is within the contract between the corporation and its stockholders. Thus the majority, where authority is conferred upon the corporation by its charter, may bind the minority by a vote to increase or reduce the capital stock, or to issue preferred stock, or to consolidate with another corporation. * * * In some states there are general laws authorizing corporations to alter or amend their articles or charter, subject to prescribed limitations, and such laws are binding, of course, upon all persons who become stockholders of corporations while they are in force." * * *

We have already held that, when the right to amend generally is reserved in the articles of incorporation, such reservation constitutes a binding agreement between all of the stockholders to the effect that the articles may be amended by the number specified therein in any particular which could have originally been agreed upon and inserted in the articles, although such amendment without such an agreement could not have been made under the statute without the consent of all the stockholders. Nelson v. Keith-O'Brien Co., 32 Utah 396, 91 P. 30. We are also convinced that the right of amendment as set forth in the authorities cited herein is in consonance with reason and justice, and in no way conflicts with or invades the vested rights of any stockholder. While much has been said respecting the relation which a preferred stockholder bears to the corporation and to the holders of common and preferred stock of another class, and that in any event he is only a stockholder and not a creditor, yet it is recognized by practically all the courts that the issuing of preferred stock is a very convenient, and under certain circumstances may be the only practical, means a corporation has of raising the necessary funds to maintain its credit, and may even become necessary to pre-

vent bankruptcy and dissolution. In no event has a preferred stockholder a specific lien upon the assets of the corporation. At most he has but a conditional promise or obligation of the corporation to pay, and in case the corporate business is discontinued, and its affairs are wound up, he, as against the common stock, or inferior classes of preferred stock, may be, and ordinarily is, entitled to preference. He, however, by reason of the right to amend and change the articles of incorporation, takes his stock subject to such right. In the very nature of things, therefore, the issue and sale of preferred stock cannot affect the rights of stockholders, whether holders of common or preferred stock, in a greatly different way than such right is affected by the issue of promissory notes or other unsecured obligations. Such obligations do not, as against the company or its creditors, constitute liens like mortgages.

In the case at bar no one could have doubted the right of the company to secure funds by mortgaging its assets, if it were done in good faith to protect its credit or to further its business interests. Had it done so, appellant's stock and his right to dividends would have been subject to the indebtedness so created and secured, whether it were large or small. Are his legal rights or the value of his shares of stock affected in a different way or to a greater extent by the issue of the class A stock than would have been the case by the issue of bonds, or even by the giving of promissory notes secured by mortgage upon the property of the company? But the way to obtain necessary funds is not always open to a corporation by mortgaging or pledging its property. Where the corporation is engaged in the mercantile business, it is not always practical to mortgage the stock of goods from which sales are continually made in due course of business. Moreover, such a course at once affects, if not destroys, corporate credit, and this may lead to ultimate insolvency and dissolution. The issue of preferred stock may thus not only be a convenient and practical method of raising the necessary funds to successfully continue its business, but it may be the only practical way out of a dilemma which may threaten the very life of the corporation. There is, therefore, much wisdom, as well as utility, contained in the statute which authorizes a corporation to issue different kinds or classes of stock, and which permits it to amend its articles so as to accomplish that result, where the right was not exercised at the organization of the corporation, or, if exercised, to increase the issue of such stock and to further classify the same. If such a right were denied by the courts, then a rival in business could easily obtain a few shares of stock in any corporation and possibly prevent it from raising the necessary funds to continue in business, and thus he could get the field to himself. If to amend the articles of incorporation so as to issue preferred stock and to classify the same invades a constitutional right, then, of course, a business rival who is a stockholder may prevent the amendment without giving his consent, and no one could complain. If, however, to so amend the articles does not invade such a right, then he may not complain, although it may affect the value of his stock. The latter might be the effect upon his stock in case of a mortgage or other pledge of the corporate property to secure a

debt, and yet no one contends that he could prevent the giving of a mortgage, if necessary to raise funds, and of the necessity to do so the governing body of the corporation, if acting in good faith, would ordinarily be the judge. No one doubts that a majority of the stockholders could authorize a loan and a pledge of the corporate property to secure its payment.

In our judgment, where the right of amendment exists, as under our statute, there can be no distinction between an amendment authorizing the issuance of preferred stock and one which authorizes both the issuance of such stock and the classification thereof. The same legal principle is involved in both cases.

Judgment affirmed.

LONSDALE SECURITIES CORPORATION v. INTERNATIONAL MERCANTILE MARINE CO. VOLK v. SAME.

Court of Chancery of New Jersey, 1927. 101 N.J.Eq. 554, 139 A. 50.

BENTLEY, VICE CHANCELLOR. On bill for injunction.

While the matter to be decided was heard on the return of an order to show cause, all parties have agreed and stipulated in open court, not only that the above-entitled causes should be consolidated and argued and heard together, but each one also agrees that it shall be decided as if on final hearing, so that an appeal may be prosecuted and submitted to the Court of Errors and Appeals within the shortest possible space of time and the issues raised put at rest once and for all.

In 1893 the defendant's predecessor was incorporated in this state and entered upon the shipping business in a comparatively modest way, which it continued to follow until 1902 when the present company was organized providing for a capital stock of $120,000,000, divided into 600,000 shares of preferred stock with a par value of $100, and a like number of shares of common stock with the same par value. There is actually issued and outstanding in the hands of the public a little more than 500,000 shares of preferred and a little less than 500,000 shares of common stock.

That portion of the certificate of incorporation of the defendant, which fixes the rights of the owners of shares of preferred stock, reads as follows:

"Fourth. That the amount of the total authorized capital stock of the company is $120,000,000, divided into 1,200,000 shares of the par value of $100 each, of which 600,000 shares shall be preferred stock and 600,000 shares shall be common stock.

"The holders of the preferred stock shall be entitled to receive, when and as declared, from the surplus or net profits of the company, yearly dividends at the rate of 6 per centum per annum, and no more, payable semiannually on dates to be fixed by the by-laws. The dividends on the preferred stock shall be cumulative, and shall be payable before any dividend on the common stock shall be paid or set apart; so that, if in any year, dividends amounting to 6 per centum shall not

have been paid thereon, the deficiency shall be payable before any dividends shall be paid upon or set apart for the common stock.

"Whenever all cumulative dividends on the preferred stock for all previous years shall have been declared and shall have become payable, and the accrued semiannual installment for the current year shall have been declared and the company shall have paid such cumulative dividends for previous years and such accrued semiannual installment, or shall have set aside from its surplus or net profits a sum sufficient for the payment thereof, the board of directors may declare dividends on the common stock, payable then or thereafter, out of any remaining surplus or net profits; provided, however, that the dividends upon the common stock shall be so limited that the same shall never in any one year exceed the rate of 10 per centum so long as there shall remain outstanding and unredeemed any of the 4½ per cent. mortgage and collateral trust gold bonds of the company.

"In the event of any liquidation or dissolution or winding up (whether voluntary or involuntary) of the company, the holders of the preferred stock shall be entitled to be paid in full both the par amount of their shares and the unpaid dividends accrued thereon before any amount shall be paid to the holders of the common stock; but after the payment to the holders of the preferred stock of its par value and the unpaid accrued dividends thereon the remaining assets and funds shall be divided and paid to the holders of the common stock according to their respective shares."

On July 21, 1927, the condition of the company was, and had been, such that no dividend had ever been declared on the common stock and so irregularly paid on the preferred stock that there were accumulations of arrears of dividends on such preferred stock amounting to approximately $70 per share. At that time there had been sold a portion of the defendant's former holdings for the sum of about $34,000,000, the purchase price being payable over a period of about 3 years. The property disposed of had been carried on the books of the company, including the good will thereof, at $80,000,000, so that there was a book loss of approximately $46,000,000 by reason of the transaction. It is undenied that the corporation is solvent.

Realizing that a continuation of the status quo could not be continued indefinitely without resultant ruin, a resolution was adopted on the said 21st day of July by the board of directors of the company setting forth the condition of the stock distribution, the opinion of the board deeming it advisable that all of its stock be readjusted and reclassified in the manner presently to be shown, and submitting to the stockholders the following scheme to accomplish those objects: The existing preferred shares were to be replaced by 120,000 shares of preferred stock without par value, and the existing common stock was to be converted into 720,000 shares of common stock without par value. Upon the change being authorized, the holders of preferred stock were to turn the same in for cancellation, and were to receive in return for each five shares so surrendered one share of the new preferred stock without par value and five shares of the common stock without par value. The common stock was to be exchanged on the basis of one share of the new common stock without par value

for five shares of the old par value stock. The preferred stock was to yield dividends at the rate of $6 per share annually, and such dividends were to be accumulative and have the usual preference over the common stock; namely, no dividend on the common at any time, if any arrears should exist on the preferred stock dividends for any year. It was further to be provided that the preferred stock should carry the customary preference on dissolution at the rate of $100 for each share. The right of the company to redeem the preferred stock at the rate of $100 per share was given.

Notice of the stockholders' meeting was regularly given, and thereupon various of the complainants filed their respective bills, one of which was presented to Vice Chancellor Church who thereupon allowed an order to show cause returnable before me, and both his order and mine restrained the filing of the amendments of the certificate of incorporation or taking any step to carry the same into effect. The company was permitted to hold its meeting and vote on the proposed plan. At that meeting there were cast in favor of the adoption of the resolution of the board of directors 379,998 shares of the common stock and 366,973 shares of preferred stock, representing well above the statutory majority of each class of stock required for the adoption of the resolution. It appears that out of 369,324 shares of preferred stock represented at the meeting only 2,361 shares at the most were voted in the negative.

There is thus presented the familiar situation created by a very meager minority objecting to the efforts of the managers of an unfortunate industrial corporation to extricate it from an unsatisfactory financial condition. There is no suggestion of fraud leveled at the action of the board of directors, but, in fact, an express avowal of confidence on the part of the complainants in the good faith of the managers of the company in proposing this new plan of capitalization. It clearly was their duty to make every effort to end this impossible condition of affairs, and that their intentions should be above suspicion is apparent from the fact that, although the situation has been discussed on innumerable occasions, no one had been able to formulate a feasible proposal that would be more desirable, as well as from the fact that about 99 per cent. of the preferred stock represented at the meeting was voted favorably.

But the facts in this case present conditions different from any with which I have had to deal in any previous suit. There is no question of the standing of these complainants, as was the case in Windhurst v. Central Leather Co., 101 N.J.Eq. 543, 138 A. 772. The bills were promptly filed before any change had taken place in the circumstances of the company or others, and a grave question is raised as to the legality of the scheme that has been proposed.

These complainants apply to this court for the only complete and adequate protection that can be afforded their property rights. Under the contract growing out of the section of the defendant's articles of incorporation which has been set out above, they have become vested with rights as against the holders of the common shares in a surplus of at least some $17,000,000 that the company has accumulated, and also in future earnings and all the other property of the

corporation. To permit the contemplated change in the certificate of incorporation would result in divesting them of those rights in violation of our law. There are now due the preferred stockholders almost $36,000,000 of accumulated dividends. The purpose of the proposed change is expressly to divest the preferred stockholders of all right to ever collect this existing claim.

It certainly requires no argument or explanation to show that any such change as is contemplated would result in impairing the investment value of the present preferred shares, and consequently would materially reduce the property rights of their respective holders. It has been urged that a proper spirit would cause these complainants to relinquish their strict legal rights in the common interest of the corporation and the other stockholders. Such an argument might well be addressed to the complainants by their fellow stockholders, but cannot be adopted by the court. It is trite to say that one may be generous with his own property, but it is scarcely generosity to deal lavishly with that of another. The fourth section of the existing certificate of incorporation of the defendant creates a contract between the defendant and the complainants by which the latter are clothed with certain property rights having a fixed, determinate value. In place of those rights it is intended to substitute others of a less valuable character, over the objection of the complainants. That they do object is conclusively shown by the filing of these bills. It is true that there would be placed in the hands of the owners of the new shares of stock, issued to replace the preferred shares intended to be retired, a greatly increased power of franchise, but the complainants neither seek, nor wish, to surrender their present rights for the one offered in their stead, and it is beyond the power of the corporation, this court or the Legislature to compel it.

It seems to me, notwithstanding the disagreement of the learned counsel for the defendant, the situation is controlled, so far as the rights of the preferred stockholders in the surplus is concerned, by the decision in Day v. U. S. Cast Iron Pipe & Foundry Co., 95 N.J. Eq. 389, 123 A. 546. In that case, after payment of dividends on the preferred stock for the year 1922, it was proposed to pay a dividend on the common stock out of earnings of previous years, during which previous years no dividends had been declared on the preferred stock. In the same case in the Court of Errors and Appeals (96 N.J.Eq. 736, 126 A. 302), Judge White clearly and, to my mind, unanswerably explained the reason upon which the affirmance of Vice Chancellor Backes' decision should have been placed; and, as I read the opinion, it is because the Legislature has declared by the eighteenth section of the General Corporation Act (chapter 185, P.L.1896 [2 Comp.St.1910, p. 1608]) that:

"* * * The dividends upon cumulative preferred stock have at all times, and for all years, past and present, until paid, priority in payment over any and all unpaid dividends upon common stock, whether the net earnings for any particular past or present year were or were not sufficient to pay the stipulated cumulative dividends upon preferred stock for that year." Pp. 740, 741 (126 A. 304).

At the present time the holders of the existing preferred stock would be entitled to all of the existing surplus if the directors should decide to declare a dividend. If that stock is retired in accordance with the proposed plan, then it is readily seen that the requirements of the relatively few shares of no par value preferred stock might be satisfied out of a portion of the surplus, and the balance thereof devoted to a payment on the no par value common stock which would represent and stand in the place of the present common stock. This would be an indirect means of accomplishing a result that is now beyond the power of the corporation.

Not only would the change result in an injury to the future, as well as the past, dividend rights of the preferred stockholders, but it would also interfere with and materially diminish or abolish vested rights.

What has already been said renders it unnecessary to deal with questions decided in all the cases of the class commencing with Kean v. Johnson, 9 N.J.Eq. 401, and ending with Allen v. Francisco Sugar Co., 92 N.J.Eq. 431, 112 A. 887. It also obviates examination of the other issues raised by the complainants, both constitutional and otherwise.

An injunction should be allowed, and, in view of the stipulations referred to above, it should be a perpetual writ.

DAVIS v. LOUISVILLE GAS & ELECTRIC CO.

Court of Chancery of Delaware, 1928. 16 Del.Ch. 157, 142 A. 654.

Bill for injunction by John J. Davis and others as executors of the will of Joshua B. F. Breed, deceased, and others, against the Louisville Gas & Electric Company. Restraining order denied.

Injunction bill to restrain the filing of an amendment to the defendant's certificate of incorporation. The defendant was incorporated on February 17, 1913, with an authorized capital of one hundred and twenty thousand shares of preferred stock (one hundred dollars par) and sixty thousand shares of common stock (one hundred dollars par). By amendment to its certificate of incorporation adopted July 29, 1913, the authorized capital was increased to one hundred and fifty thousand shares of preferred and eighty thousand shares of common. By further amendment of the certificate adopted June 26, 1925, the capital structure of the defendant was changed so as to substitute for its then authorized classes of preferred and common shares an authorized capital of one million, three hundred thousand shares of stock without nominal or par value, consisting of eight hundred thousand shares of Class A common stock and five hundred thousand shares of Class B common stock. This is the defendant's capital structure at the present time.

The Class A common has no voting rights. It is redeemable at any time at $32.50 per share. Upon dissolution or liquidation it is entitled to receive $25.00 per share before anything is paid to Class B common, after which payment Class B is entitled to the remainder. Class A is entitled to receive a dividend out of earnings at the rate of $1.50 per share per annum before Class B is entitled to receive anything.

After the Class A's dividend of $1.50 is provided for, Class B is entitled to receive dividends at the rate of $1.50 per share per annum out of the remaining surplus or net profits. Whenever each class has received for any quarter dividends at the rate of $1.50 per annum, the directors are authorized to declare additional dividends for such quarter out of the remaining surplus or net profits up to but not in excess of the rate of fifty cents per share per annum to the holders of both classes. Thereafter, further dividends may be declared for the then current quarter to the two classes in the proportion, share for share, of one for Class A and four for Class B; that is to say, for each twenty-five cents declared to a share of Class A, each share of Class B shall be entitled to receive one dollar.

It is now proposed to amend the certificate of incorporation by changing the terms and conditions of Class A and Class B stock by providing that whenever for any quarterly dividend period dividends at the rate of $1.50 per annum have been paid to Class A stock and a like dividend has been paid to Class B stock, any further dividends shall be declared on both classes share and share alike without distinction as to classes. It is further proposed to destroy by amendment the right of the corporation to redeem Class A stock at $32.50 per share.

A stockholders' meeting was called for May 16, 1928, to pass upon the proposed amendment. On that day the meeting convened and the vote was as follows: 359,649 shares of Class A common (outstanding 507,381) and 244,864 shares of Class B common (outstanding 257,956) voted in favor of the amendments, while 1824 shares of Class A and 6150 shares of Class B voted against the amendment.

Though the vote was favorable to the amendment, yet the officers of the corporation have, by agreement, withheld the filing of amending papers with the Secretary of State pending decision upon the present motion for a restraining order.

It is now asked that a restraining order issue restraining the corporation from taking the necessary steps under the law to effectuate the amendment.

Heard on bill, answer and affidavits.

THE CHANCELLOR. The complainants are holders of Class B stock. They contest the right of the defendant to amend its certificate of incorporation in the manner proposed for two reasons—first, because the corporation is without lawful power to adopt the amendment, and second, conceding the power to exist, the changes proposed by the amendment are nevertheless unfair, inequitable and a fraud upon the complainants, and should therefore be enjoined.

Logically the first contention should be disposed of first, because if it be well grounded the second need not be considered.

First, then, has the corporation power under the law to adopt the amendment in question? The complainants concede that if the defendant corporation has the power which the amendment to section 26 of the General Corporation Law, under which the defendant was incorporated, undertakes to confer upon corporations, then the question of power to adopt the capital changes proposed must be answered

in favor of its exercise. The corporation was created in 1913. That the corporation possessed all the powers conferred upon it not only by its certificate of incorporation, but as well those which the act itself conferred upon all corporations created under it, cannot be questioned. Peters v. U. S. Mortgage Co., 13 Del.Ch. 11, 114 A. 598; Morris et al. v. American Public Utilities Co., 14 Del.Ch. 136, 122 A. 696; Bouree et al. v. Trust Francais, Inc., 14 Del.Ch. 332, 127 A. 56. Section 26 of the act is the section dealing with amendments to corporate charters, and the power to amend conferred by that section as it existed at the time this corporation was created was consequently conferred upon it by the law creating it. The complainants contend that the power to amend thus conferred on the defendant at the time of its creation by section 26 of the act was not such as to embrace within its scope a power to effect so fundamental and radical a change in the corporate structure as the proposed alteration contemplates. Whether this contention is tenable will not now be considered. For the moment, it will be assumed that it is and that the power to effect changes of the kind under consideration was not conferred by section 26 as it existed in 1913 when the defendant was created.

The section (26) was amended in 1927 (35 Del.Laws, c. 85, § 10). Power to enact amendments was reserved by the state in section 82 of the act under which the defendant was created. That section provides:

"This chapter may be amended or repealed, at the pleasure of the Legislature; * * * this chapter and all amendments thereof shall be a part of the charter of every such corporation except so far as the same are inapplicable and inappropriate to the objects of such corporation."

Section 26 in its 1927 amended form was so worded as to confer upon corporations a power to amend their certificates of incorporation sufficiently comprehensive to embrace the sort of amendment proposed to be effected by the defendant in this case. The complainants concede this. But they argue, the defendant cannot justify the proposed amendment under section 26 as amended in 1927, for the reason that it was beyond the power of the Legislature to authorize such a change in the contractual relations existing between the corporation and its stockholders and between the stockholders inter sese as the proposed amendment to the certificate contemplates. The contract now subsisting between the corporation and its members as well as among the stockholders of the two classes, gives to the B common the right to retire the A common at $32.50 a share, and when a certain point is reached in distributing earnings as dividends a further right to receive thereout one dollar to every twenty-five cents paid to the A stock. These rights, say the complainants who are B stockholders, constitute material and fundamental contract rights which they now enjoy and which but for the power conferred by the 1927 legislation the corporation and the majority of stockholders however great could not take from them without their consent. Hence it follows, they argue, that in so far as the 1927 enactment under-

takes to disturb these rights, it is invalid as an act impairing the obligation of a contract. * * *

The line of demarcation between what constitutes a matter of public as distinguished from one of private interest in corporate activities is admittedly exceedingly difficult to define. The very fact that the general corporation acts found in the various states deal in great detail with innumerable aspects of the contract in what upon a glance would be regarded as relating to its private as distinguished from its public character, has some force to suggest that the state, by dealing with such subjects in the statute rather than by leaving them to be arranged by the corporate membership, has impliedly impressed upon such matters the quality of public interest and concern. Certain it is that the state in authorizing the creation of corporations is interested as a matter of public policy in seeing to it that its corporate creatures shall possess such powers as are best calculated to promote the corporation's welfare, advance its interests, and facilitate the meeting of its business and financial needs. Questions having to do with stock, its kinds, classes, preferences, participations and qualifications, which a corporation may issue, are questions that are most intimately bound up with the future welfare of the corporation and may have a most material relation to the continuance in esse of the entity which the state has created. Nor is it unreasonable to assume that the state, thus recognizing the vital importance to the corporate life of questions dealing with its capital structure, further recognized the unwisdom of casting in an unchanging mould the corporate powers which it conferred touching these questions so as to leave them fixed for all time. May it not be assumed that the Legislature foresaw that the interests of the corporations created by it might, as experience supplied the material for judgment, be best subserved by an alteration of their intracorporate and in a sense private powers, and, in the interest of a public policy which coveted their successful progress, have meant to reserve to itself by the general amendment clause a right to alter or enlarge such powers? * * *

The conclusion I reach on this branch of the case is that the power reserved by the Legislature to amend the act under which the defendant was created, and subject to which every stockholder acquired and holds his stock, is broad enough to embrace within its purview the amendment of 1927. Even conceding, if need be, that the power of amendment reserved by the Legislature can extend only to those matters that are of public concern, yet it does not follow that the amendment here under debate is to be condemned. This is for the reason that the problem of financing corporate needs is so vital to the continuance in existence of corporations created under the act, the matter of stock, its kinds, classifications and relative rights, is so intimately associated with that problem, that it is difficult to escape the conclusion that the character of the statutory regulations defined by the Legislature for the meeting of that problem might very well be regarded as affected with a public interest and concern. The peculiar language of the clause by which the power of amendment was reserved by our statute would in itself point to this conclusion.

In view of the foregoing, it follows that the amendment to the act adopted in 1927, is applicable to the corporation defendant in this case. If it is, then it is conceded that so far as the question of power is concerned, the proposed alteration of the certificate of incorporation has statutory warrant. * * *

Second, the power being found to exist to adopt the proposed amendment of the certificate, are its terms so unfair and inequitable as to constitute a fraud on the complainants who hold B stock? This question is assumed by the parties to be a pertinent one. That the amendment, if adopted, will take from B stock certain material rights which it now enjoys cannot be doubted. The defendant is said to be in a prosperous condition and its business and earnings appear to be growing at a satisfactory rate. By taking away the right to redeem the A stock at $32.50 a share, the complainants argue that the B stock is deprived of the opportunity to retire on favorable terms that stock as a sharer with it in the earnings which have every prospect of increasing in amount. But, it is argued, a more glaring injustice is proposed to be done to the B stock by the proposal that when a certain point shall have been reached in disbursement of earnings as dividends, the distribution shall thereafter be in equal proportions to A and B instead of in the proportion now provided for of four to one, that is on the basis of one dollar to B for every twenty-five cents to A. The complainants calculate that from the present financial statement of the company the proposed change would enable the directors by a dividend declaration out of earnings now on hand to divert something over $200,000 to A stock which, if the proposal be not adopted, would go to B stock.

All this, they argue, is unfair, inequitable and a fraud on the B stockholders. The defendant justifies the proposed change as one that is for the best interest of the corporation and for the stockholders as a whole. The company is a growing one and is in need of additional funds for its expansion. Such additional funds, it says, can be best and most advantageously obtained by the sale of its A stock. Sale of that stock with its present redemption feature and its restricted dividend participations cannot in the judgment of the managing board of directors be effected in sufficient amount to meet the company's needs and upon terms regarded as advantageous. The complainants disagree with this view. We have then a conflict in view between the responsible managers of a corporation and an overwhelming majority of its stockholders on the one hand and a dissenting minority on the other—a conflict touching matters of business policy, such as has occasioned innumerable applications to courts to intervene and determine which of the two conflicting views should prevail. The response which courts make to such applications is that it is not their function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final. The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve. * * *

The restraining order will not issue.

HUEFTLE et al. v. FARMERS ELEVATOR et al.

Supreme Court of Nebraska, 1944. 145 Neb. 424, 16 N.W.2d 855.

Suit by Gotthill C. Hueftle and others against the Farmers Elevator, a corporation, otherwise and sometimes known as Farmers Co-operative Elevator, impleaded with Gustav A. Hueftle and others, to enjoin distribution of dividends. From a decree for plaintiffs, defendants appeal.

Affirmed.

CARTER, JUDGE. This is an appeal from a decree enjoining a distribution of dividends in accordance with amendments to the articles of incorporation and bylaws of The Farmers Elevator, Eustis, Nebraska, a corporation, on the ground that said amended articles and bylaws violate the contractual rights of minority stockholders and are not consistent with the nature, purposes and objects of the corporation as stated in its original articles and bylaws.

The record shows that plaintiffs are stockholders in the corporation. They allege that The Farmers Elevator was organized for the purpose of carrying on the business of buying and selling grain, hay, livestock and other agricultural products and that it purchased an elevator and office building to carry on the business in Eustis, Nebraska. Plaintiffs then allege the intent of the directors of the corporation to distribute the profits of the corporation on the basis of and in proportion to the amount of the business done with the corporation, rather than as dividends on the stock of the corporation. It is also alleged that said corporation directors are assuming the power to recall the stock of the corporation and to give in exchange therefor a new and different type of share and certain so-called participation certificates on which they purport to pay patronage dividends rather than the stock dividends required by the articles of incorporation. It is alleged that a large amount of profits have accrued and that defendants, unless enjoined, will pay them out as patronage dividends to the irreparable injury of plaintiffs. The petition also alleges the invalidity of certain amended articles of incorporation under which the defendants are purporting to act. The petition prays for an injunction enjoining defendants from proceeding in any manner under the amended articles of the corporation.

The defendants by their answer allege that on March 4, 1943, at a regularly called meeting of the stockholders of the corporation, certain amendments to the articles of the corporation were adopted which purported to change The Farmers Elevator to a co-operative corporation and provided for the distribution of dividends upon a patronage basis. Subsequently the officers and directors adopted bylaws in conformity with the amended articles and have since proceeded to act in accordance therewith. The answer admits the purposes of the corporation as originally formed and pleads the adoption and validity of the amended articles and bylaws giving rise to the present litigation. There are additional allegations in the answer to the ef-

fect that plaintiffs are barred by estoppel and laches from asserting their claim.

Plaintiffs filed a general demurrer to the answer which the trial court sustained. Defendants elected to stand on their answer, an injunction decree was entered as prayed for in the petition and an appeal taken therefrom. The correctness of this ruling is the sole question raised by the appeal.

The fundamental question to be determined is whether the adoption of amended articles of incorporation by a majority of the stockholders, whereby it is sought to convert a stock corporation organized under the general corporation laws of the state into a co-operative corporation distributing dividends on a patronage basis, is violative of the contractual rights of minority stockholders and constitutes such a fundamental change in the nature, purposes and objects of the corporation as to make such amendments invalid.

The purpose of the suit is to prevent the distribution of the profits of the corporation in the manner provided by the amended articles and bylaws. It is self-evident that stockholders under the original articles will be deprived of dividends to which they were entitled thereunder. By their purchase of stock they acquired a contractual right to share in the net profits in the form of dividends on stock. An attempt to make a distribution of net profits on a patronage basis constitutes a violation of plaintiffs' contract rights.

"It is settled law that a corporation has no power to adopt by-laws which impair or destroy the obligations of contracts or rights thereunder or vested rights, and that by-laws which have that effect are invalid and unenforceable against a person whose rights are impaired or destroyed thereby." 8 Fletcher, Private Corporations (Perm. ed.) sec. 4188. The foregoing rule applies with equal force to amendments to the bylaws.

In a case very similar on fact and principle this court said: "In 1916 there was an attempt to amend the articles of incorporation by changing the Farmers Elevator Company to a co-operative association within the meaning of the statute cited. Later defendants planned to distribute profits under the amendment. Such a course, if pursued, would deprive plaintiffs of dividends to which they were entitled under their contracts as original stockholders and would destroy their contractual rights. This neither the legislature nor the defendants can lawfully do." Allen v. White, 103 Neb. 256, 171 N.W. 52.

In Supreme Commandery Knights of the Golden Rule v. Ainsworth, 71 Ala. 436, 46 Am.Rep. 332 the court said: "A corporation has not capacity, as the legislative power from which it derives existence has not competency, by laws of its own enactment, to disturb or divest rights which it had created, or to impair the obligations of its contracts, or to change its responsibilities to its members, or to draw them into new and distinct relations."

The amendments change the fundamental arrangement and plans of the corporation as it was organized when plaintiffs became stockholders and impair the contractual rights which they then acquired. It follows that the amendments and the proceedings of the defendants taken thereunder are void.

Defendants urge that plaintiffs are estopped to question the validity of the amended articles and bylaws for the reason that they permitted defendants to advertise and solicit business for approximately seven months without objection thereto, that the articles and bylaws provided for their own amendment at the time plaintiffs purchased their stock and they are bound thereby, and that previous amendments to the articles and bylaws had been made to which plaintiffs had acquiesced. We find no merit in these contentions. A delay of seven months cannot be deemed unreasonable where, as here, no effort was made to distribute dividends on a patronage basis until shortly before the suit was brought.

While it is true that the right to amend the articles and bylaws was reserved at the time plaintiffs became stockholders, the right to amend was not absolute. The power to amend articles and bylaws is an incident of the power to adopt them and a general reservation of the right to amend ordinarily creates no different situation than if it were not reserved at all. In either event, the fact that a stockholder may purchase stock at a time when the right to amend the articles and bylaws is reserved does not operate to confer authority to make an amendment which will amount to the destruction or impairment of the vested or contract rights of the member. Neither does the fact that a stockholder acquiesces in previous amendments estop him from asserting his rights when a subsequent article or bylaw is amended which materially affects his interests. * * *

We are of the opinion that the amendments to the articles of incorporation and bylaws here involved constitute such a fundamental change in the nature, purposes and objects of the corporation and such an impairment of the contractual rights of the plaintiffs, that the trial court was correct in declaring their invalidity. The trial court was right in sustaining the demurrer to defendants' answer and in entering the injunction order prayed for in plaintiffs' petition when defendants elected to stand on their answer.

Affirmed.

D. ENTERPRISE ENTITY UNDER DEFECTIVE INCORPORATION (DE FACTO CORPORATIONS)—MANAGEMENT UNDER INCOMPLETE CONTRACT

DELAWARE GENERAL CORPORATION LAW

Sec. 69. *Want of Legal Organization No Defense in Actions:*—No corporation organized under this Chapter or existing under the laws of this State, shall be permitted to set up, or rely upon the want of legal organization as a defense to any action against it; nor shall any person transacting business with such corporation, or sued for injury done to its property, be permitted to rely upon such want of legal organization as a defense.

This section shall not be construed to prevent judicial inquiry into the regularity or validity of the organization of the corporation or its lawful possession of any corporate power it may undertake to

assert in any other suit or proceeding where its corporate existence or the power to exercise the corporate rights it asserts is challenged, and evidence tending to sustain such challenge shall be admissible in any such suit or proceeding.

PEOPLE v. FORD

Supreme Court of Illinois, 1920. 294 Ill. 319, 128 N.E. 479.

Information in the nature of quo warranto by the People against E. E. Ford and others to determine the legality of the organization of a corporation. From a judgment dismissing the information, after overruling a demurrer to the plea, the People appeal. Affirmed.

DUNN, J. The Fifty-First General Assembly passed an act in relation to corporations for pecuniary profit, known as the General Corporation Act, which was approved on June 28, and became effective July 1, 1919. Laws of 1919, p. 316. Section 4 provides that—

"Whenever three or more adult persons, citizens of the United States of America, at least one of whom shall be a citizen of this state, shall desire to form a corporation under this act, they shall sign, seal and acknowledge before some officer, competent to take acknowledgment of deeds, a statement of incorporation setting forth the following: [Here follow thirteen paragraphs stating the facts to be contained in the statement.]"

The section closes with the sentence that—

"Such statement shall be filed in duplicate in the office of the secretary of state on forms prescribed and furnished by the secretary of state."

Section 5 provides that—

"Upon the filing of such statement, the secretary of state shall examine the same, and, if it is in conformity with the provisions of this act, he shall indorse thereon the word 'Filed' followed by the month, day and year of such filing. Upon such filing the corporation shall be deemed fully organized and may proceed to business."

On September 5, 1919, a certificate of incorporation of the Washer Maid Company was filed in duplicate in the office of the secretary of state. The Attorney General afterward, by leave of the court, filed in the circuit court of Cook county an information in the nature of quo warranto against E. E. Ford, A. J. Fisher, and C. R. Gilbert, charging them with having unlawfully usurped, intruded into, held, and executed the office of directors of a pretended corporation known as the Washer Maid Company, under color of a void and illegal certificate of incorporation, and calling upon them to show by what warrant they exercised such privileges.

The respondents filed a plea showing the various steps taken for the organization of the corporation, setting forth in hæc verba the statement filed by them, alleging that it was made on forms prescribed and furnished by the secretary of state, which were executed and acknowledged by the respondents, and that the respondents had in all respects complied with the requirements of the General Corporation

Act. The Attorney General demurred and for special cause of demurrer showed that the respondents in their statement of incorporation did not sign, seal and acknowledge the same, but, on the contrary, failed to seal the same or to affix their seals to said statement of incorporation, as required by the General Corporation Act. The statement set forth in the plea shows the signatures of the respondents as follows:

E. E. Ford,
A. J. Fisher, } Incorporators.
Chas. R. Gilbert,

The word "seal" does not appear, nor are there any letters, scrawl, or marks which might be regarded as a seal, unless it is the bracket which joins the names, and neither the statement itself nor the certificate of acknowledgment contains any reference to a seal. The court overruled the demurrer, and, the Attorney General electing to stand by it, the information was dismissed. An appeal was taken, and at the June term the cause was submitted, with a request by both parties for an early decision because of the public importance of the question involved. * * *

The question presented was whether the requirement that the incorporators shall seal the statement is mandatory or directory. It was argued on behalf of the people that the requirement of the seal is a condition precedent to the legal existence of a corporation. A somewhat similar question arose early in the history of the state in the case of Cross v. Pinckneyville Mill Co., 17 Ill. 54. The act of 1849, to authorize the formation of corporations for manufacturing, agricultural, mining or mechanical purposes, provided that any three or more persons desiring to form a company for such purpose should make, sign, and acknowledge, and file "in the office of the clerk in the county in which the business of the company should be carried on and a duplicate thereof in the office of the secretary of state, a certificate in writing," in which should be stated the name of the company and other facts mentioned in the statute. It was further provided that when the certificate should have been filed as aforesaid the persons who should have signed and acknowledged, and their successors, should be a body politic and corporate. In the case mentioned the duplicate certificate of organization had not been filed in the office of the secretary of state, but the court held that fact unimportant to defeat the organization or rights growing out of it; that there is a well-settled distinction between mandatory and directory provisions, and that carrying out of the true intention of the Legislature and effectuating the object of the law would not be promoted by strict technical constructions, converting every direction and detail of power into a mandatory prerequisite of corporate existence.

More recently a question arose as to the effect of the failure to mail notices of the meeting of subscribers of the capital stock to elect officers, as required by section 3 of the Corporation Act of 1872 (Laws 1871–72, p. 296). We said:

"The statute prescribes a certain course to be pursued in organizing a corporation in this state. It does not necessarily follow, however,

that any departure from that course will prevent a corporation from becoming one de jure. Whether or not such departure will have that effect depends upon the nature of the provision which is violated. If it is a mandatory provision, a failure to substantially comply with its terms will prevent the corporation from becoming one de jure; but if the provision is merely directory, then a departure therefrom will not have that consequence."

It was held that it was immaterial whether or not notice had been given in the manner directed by the statute; the persons entitled to notice having waived it and actually attended the meeting, so that the purpose of the statute in requiring the notices to be given was accomplished. Butler Paper Co. v. Cleveland, 220 Ill. 128, 77 N.E. 99, 110 Am.St.Rep. 230. * * *

The requirement of a seal in the execution of documents by individuals has become a mere formality. It means nothing. Private seals no longer exist as a means of execution of specialties, for even an individual scrawl is not required. In most deeds the word "seal" is printed on the blank form which is used, and the grantor does not know whether he has used a seal or not. It depends upon whether the word was printed on the paper or not. The solemnity of the sealed instrument is purely Pickwickian and no longer represents an idea. While courts of law in this state cannot disregard the legal quality of the sealed instrument, courts of equity frequently relieve parties from the difficulties arising from the application of the rigid rules of the common law to such instruments.

We may look to the intention of the statute in determining the effect of an omission to add the seal. The purpose is to make a public record of the corporation, the definition of its powers, the amount of its stock, the names of its stockholders, its location, and other facts in connection with it, which are of interest to the public to know, and of the state in its supervision over corporations to be acquainted with. The addition of a seal is of no importance for these purposes. It is not of the essence of the thing to be done, and no prejudice can result from its omission. The essential act of making the statement, though not in the precise manner indicated, accomplishes the substantial purpose of the statute, and that is sufficient. It would not be carrying out the intention of the Legislature to hold that the addition of a scrawl by the signers of the statement is mandatory and its omission invalidates the incorporation.

For these reasons the judgment of the circuit court was affirmed.

Judgment affirmed.

FARMER, J. (dissenting). The Legislature saw fit to require the statement to be under seal. Whether this was an important requirement or not, the Legislature had the power to, and did make it. Courts cannot disregard it, on the ground that it was a useless requirement, or that the Legislature did not mean what it said.

GARTSIDE COAL CO. v. MAXWELL.

Circuit Court of the United States, E. D. Missouri, 1884. 22 F. 197.

BREWER, J., (*orally.*) In this case the facts are these: There was a corporation, or what pretended to be a corporation, which purchased coal from the plaintiff, and the transactions extended through a series of years. The defendants, or the defendants' so-called corporation, failed to pay,—became insolvent; and this action is to charge those who were the stockholders in this supposed corporation as though they were partners; and the basis of the claim is that there was no corporation; that whatever it assumed or pretended to be, although it called itself a corporation, and attempted to transact business as a corporation, yet in fact it was no corporation, and had no legal existence; and that these parties who were acting as though they were stockholders in this corporation were really not stockholders, and must therefore individually be held as partners to have made the purchases.

It is very clear to my mind that this attempted incorporation was invalid, and that if it had ever been challenged by the officer of the state, in proper proceedings, its exercise of corporate powers would have been enjoined; but, while I think that is unquestionably so, it does not seem to me to follow that those who were supposing themselves stockholders in this corporation can be held personally liable. I think the true rule is this: that where persons knowingly and fraudulently assume a corporate existence, or pretend to have a corporate existence, they can be held liable as individuals; but where they are acting in good faith, and suppose that they are legally incorporated, —that they are stockholders in a valid corporation,—and where the corporation assumes to transact business for a series of years, and the assumed corporate existence is not challenged by the state, then they cannot be held liable, as individuals, as members of the corporation.

Of course, the converse is perfectly true, that a person who deals with a corporation, or gives to an assumed corporation a note, cannot question the corporate existence of that party with whom he has dealt or to whom he gave his note. So, on the other hand, where a person deals with what he supposes is a corporation, with what all parties think is a corporation, where he gives his credit to that supposed corporation, he cannot afterwards, when it turns out that it is not validly incorporated, turn round and say, "Well, I dealt with this supposed corporation; I thought it was a corporation; I trusted it as a corporation; I sold goods to it as a corporation; but it seems when it first attempted to become incorporated that there was some defect or irregularity in its proceedings, so that it did not become legally incorporated, and therefore you who are stockholders will be held personally liable." I do not think that can be done, and judgment will be entered for the defendant.

LOWELL-WOODWARD HARDWARE CO. v. WOODS et al.

Supreme Court of Kansas, 1919. 104 Kan. 729, 180 P. 734.

Action by the Lowell-Woodward Hardware Company against G. R. Woods, Ed. Semke, and others, partners under the firm name and style of Superior Leasing Company. Judgment for plaintiff, and defendant Semke appeals. Affirmed.

MASON, J. An action was brought in the name of the Lowell-Woodward Hardware Company, describing itself as a Colorado corporation, against several persons alleged to constitute a partnership, upon a promissory note. One of the defendants, Ed. Semke, filed an answer consisting of a verified general denial. Judgment was rendered for the plaintiff, and Semke appeals.

1. The appellant's contention is that there was no competent evidence of the plaintiff's corporate existence, or of his being a member of the partnership described. A witness for the plaintiff testified that it was a corporation, over an objection that the question called for a conclusion, and the ruling is complained of. On cross-examination he stated in full the basis of his opinion, so that the first answer was not prejudicial. Insurance Office v. Woolen-Mill Co., 72 Kan. 41, 82 P. 513. He said that the plaintiff was running a hardware store, and that he inferred it was a corporation from its name and its mode of doing business; that a bank president had told him it was a corporation. Possibly this evidence did not tend to show even the de facto existence of the corporation—which is all that could be required (7 R.C.L. 105)—but that will not avail the appellant. One who enters into a written contract with a party described therein as a corporation is precluded, in an action brought thereon by such party under the same designation, from denying its corporate existence. 7 R.C.L. 105, 106; 10 Cyc. 521. Here the payee was styled in the note—"The Lowell-Woodward Hardware Company," a title which prima facie imports a corporation. 3 Encyc. of Ev. 599; 7 R.C.L. 699; note, Ann. Cas.1912A, 969, second column. There is some difference of opinion as to whether one contracting with an organization styling itself a "company," there being nothing further in the language used to indicate its character, the term "corporation" not being employed, can be heard to deny its corporate capacity when sued by it upon the contract. The cases bearing on the question are collected in Ingle System Co. v. Norris & Hall, 132 Tenn. 472, 178 S.W. 1113, which holds, in accordance with what it regards as the weight of authority, that such defense cannot be made. See, also, Toledo Computing Scale Co. v. Young, 16 Idaho, 187, 101 P. 257; Bremen Foundry & Machine Works v. Boswell (Ga.App.) 96 S.E. 182; Grande Ronde Lumber Co. v. Cotton, 12 Colo.App. 375, 55 P. 610. In the leading case to the contrary (Welland Canal Co. v. Hathaway, 8 Wend. [N.Y.] 480, annotated in 24 Am.Dec. 51), the decision turns upon the fact that some of the elements of equitable estoppel, according to the accepted definition, are lacking. We agree that no full, formal, technical estoppel to deny corporate existence arises from such a state of facts, but we

think it accords with modern views of good practice and tends to promote substantial justice to hold, and we do hold, that one who has signed a promissory note running to a payee described by a name appropriate to a corporation, although not employing that term, cannot, in an action brought against him thereon by such payee under the same name, in which it alleges itself to be a corporation, be heard to question the plaintiff's corporate existence, unless upon a showing that his obligation to make payment would be thereby affected. The defendant, having given his promise to pay the sum indicated to the payee named, should not be permitted to escape or delay performance by raising an issue as to the character of the organization to which he is indebted, unless his substantial rights might be thereby affected, which would only be under exceptional conditions. It is thoroughly settled that in such a situation the defendant cannot attack the regularity of the plaintiff's organization, or take any advantage of the fact that it has no legal standing as a corporation. No good reason is apparent why, having explicitly promised to make payment to the concern by which he is sued, he should be permitted to question its de facto any more than its de jure character—to inject into the case an issue having no bearing on his obligation to make payment. * *

The judgment is affirmed.

All the Justices concurring.

HARRILL v. DAVIS.

Circuit Court of Appeals of the United States, Eighth Circuit, 1909. 168 F. 187.

In Error to the United States Court of Appeals in the Indian Territory. * * *

SANBORN, CIRCUIT JUDGE (after stating the facts as above). The patent and indisputable facts in this case are that the four defendants associated themselves together, and from June, 1902, until December 22, 1902, actively engaged in purchasing lumber, material, and labor of the plaintiff, and in constructing a cotton gin under the name "The Coweta Gin Company," and in conducting the business of buying, selling, and ginning cotton for profit under the name "The Coweta Cotton & Milling Company," and that during this time they incurred more than $4,700 of the indebtedness of $5,145.48 for which this action was brought. On December 22, 1902, they made their first real attempt to incorporate, and for the first time took on the color or appearance of a corporation. On that day they filed articles of incorporation with the clerk of the Court of Appeals, but they never filed any duplicate of them with the clerk of the judicial district in which their place of business was located, as required by the statutes in order to constitute them a legal corporation and to authorize them to do business as such. Act Feb. 18, 1901, c. 379, 31 Stat. 794; Mansfield's Dig. Laws Ark. §§ 960, 968, 979.

The general rule is that parties who associate themselves together and actively engage in business for profit under any name are liable as partners for the debts they incur under that name. It is an excep-

tion to this rule that such associates may escape individual liability for such debts by a compliance with incorporation laws or by a real attempt to comply with them which gives the color of a legal corporation, and by the user of the franchise of such a corporation in the honest belief that it is duly incorporated. When the fact appears, as it does in the case at bar, by indisputable evidence that parties associated and knowingly incurred liabilities under a given name, the legal presumption is that they are governed by the general rule, and the burden is upon them to prove that they fall under some exception to it. * * * [Citing cases.] But in every one of these authorities articles of incorporation had been filed under a general enabling act, or a charter had been issued and there had been a user of the franchise of the supposed corporation which had been colorably created by the filing of the articles or the issue of the charter before the indebtedness in question was created, while nothing of this nature had been done before the debt for the $4,700 which we are now considering was incurred. The authorities which have been recited rest upon the proposition that where parties procure a charter or file articles of association under a general law, thereby secure the color of a legal incorporation, believe that they are a corporation, and use the supposed franchise of the corporation in good faith, and third parties deal with them as a corporation, they become a corporation de facto and exempt from individual liability to such third parties, although there are unknown defects in the proceedings for their incorporation. The statement of Morawetz on Corporations, at section 748, upon which counsel seem to rely, that:

"If an association assumes to enter into a contract in a corporate capacity, and the party dealing with the association contracts with it as if it were a corporation, the individual members of the association cannot be charged as parties to the contract, either severally or jointly, or as partners. This is equally true whether the association was in fact a corporation or not, and whether the contract with the association in its corporate capacity was authorized by the Legislature or prohibited by law, or illegal"

—is too broad to be sound. Parties who actively engage in business for profit under the name and pretense of a corporation which they know neither exists nor has any color of existence may not escape individual liability because strangers are led by their pretense to contract with their pretended entity as a corporation. In such cases they act as the agents of a principal that they know does not exist, and they are liable under a familiar rule, because there is no responsible principal. 2 Kent's Commentaries (14th Ed.) 630; Queen City Furniture & Carpet Co. v. Crawford, 127 Mo. 356, 364, 30 S.W. 163. The burden is not on the strangers who deal with them as a corporation, but on themselves who act under the name of a pretended corporation, to see that it is so organized that it exempts them from individual liability, and if they fail in this they must pay the liabilities they incur, even in the absence of fraud or bad faith, upon the salutary principle that where one of two parties must suffer he must bear the loss whose breach of duty caused it.

There are cases in which stockholders who took no active part in the business of a pretended corporation which was acting without any charter or filed articles, who supposed that the corporation was duly organized, have been held exempt from individual liability for the debts it incurred; but if they had been actively conducting its business with knowledge of its lack of incorporation, those decisions must have been otherwise. Seacord v. Pendleton, 55 Hun 579, 9 N.Y.Supp. 46; Fuller v. Rowe, 57 N.Y. 23, 26.

Neither the hope, the belief, nor the statement by parties that they are incorporated, nor the signing of articles of incorporation which are not filed, where filing is requisite to create the corporation, nor the user of the pretended franchise of such a nonexistent corporation, will constitute such a corporation de facto as will exempt those who actively and knowingly use its name to incur obligations from their individual liability to pay them. Color of legal organization as a corporation under some charter or law and user of the supposed corporate franchise in good faith are indispensable to such exemption.

Under the general law of Arkansas in force in the Indian Territory, the filing of articles of incorporation with the clerk of the Court of Appeals was a sine qua non of any color of a legal corporation. Without that there was not, and there could not be, an apparent corporation or the color of a corporation. Agreements to form one, statements that there was one, signed articles of association to make one, acts as one, created no color of incorporation, because there could be no incorporation or color of it under the law until the articles were filed. Johnson v. Corser, 34 Minn. 355, 25 N.W. 799; Finnegan v. Noerenberg, 52 Minn. 239, 243, 244, 53 N.W. 1150, 1151, 18 L.R.A. 778, 38 Am.St.Rep. 552; Taylor on Private Corporations, p. 145, Roberts Mfg. Co. v. Schlick, 62 Minn. 332, 64 N.W. 826. In Finnegan v. Noerenberg, supra, Chief Justice Gilfillan well said:

"To give to a body of men assuming to act as a corporation, where there has been no attempt to comply with the provisions of any law authorizing them to become such, the status of a de facto corporation, might open the door to frauds upon the public. It would certainly be impolitic to permit a number of men to have the status of a corporation to any extent merely because there is a law under which they might have become incorporated, and they have agreed among themselves to act, and they have acted, as a corporation. That was the condition in Johnson v. Corser, 34 Minn. 355, 25 N.W. 799, in which it was held that what had been done was ineffectual to limit the individual liability of the associates. They had not gone far enough to become a de facto corporation. They had merely signed articles, but had not attempted to give them publicity by filing for record, which the statute required."

The defendants cannot escape individual liability for the $4,700 on the ground that the Coweta Cotton & Milling Company was a corporation de facto when that portion of the plaintiff's claim was incurred because it then had no color of incorporation, and they knew it and yet actively used its name to incur the obligation. * * *

Counsel insist that the defendants are not liable here because one

who deals with a corporation de facto is estopped from denying its existence as a corporation; but the true meaning and legal effect of this rule is that such a dealer is estopped from denying its existence on the ground that it was not legally incorporated. One who deals with parties who masquerade under a name which represents no corporation de facto is no more estopped from denying that it is a corporation than he would be from denying that they constituted or acted for the Union Pacific Railroad Company, or any other well-known corporation, when they did not. The fact that the plaintiff dealt with and treated the Coweta Cotton & Milling Company as a corporation did not estop it from denying that it was such before the defendants filed their articles of incorporation, because it was not a corporation de facto before that time and because the indispensable elements of an estoppel in pais, ignorance of the truth and absence of equal means of knowledge of it by the party who claims the estoppel, and action by the latter induced by the misrepresentation of the party against whom the estoppel is invoked, do not exist in the case at bar. Bigelow on Estoppel (4th Ed.) p. 679. The plaintiffs did not, and the defendants did, represent that the milling company was a corporation when it was not. The defendants had better means of knowledge of the fact than the plaintiff, and they knew it was not a corporation, and they were not induced to act on any representation of the plaintiff that it was such, or by its treatment of it as such.

Nor was the plaintiff estopped by the fact that its general manager stated under oath in its claim for a lien in May, 1903, that the milling company was a corporation, first, because the defendants were not induced to take any action by this statement from which they can suffer any injury by the proof of the truth, and, second, because one is not estopped from pursuing his true legal remedy by a mistaken attempt to pursue a supposed remedy that does not exist. Standard Oil Company v. Hawkins, 20 C.C.A. 468, 472, 74 F. 395, 398, 399, 33 L.R.A. 739; Barnsdall v. Waltemeyer, 73 C.C.A. 515, 520, 142 F. 415, 420; Bunch v. Grave, 111 Ind. 351, 12 N.E. 514, 517.

It is said that the plaintiff is estopped from denying the existence of the defendant's supposed corporation because it was one of its promoters and stockholders, but the evidence fails to convince us that it was ever either. * * *

And our conclusion is that the defendants never became a corporation de facto prior to December 22, 1902, that they never became a corporation de jure, that the indebtedness here in question was not incurred under any promise or assurance of the defendants as promoters that it should become the obligation of a corporation to be formed, that a large part of it was incurred in the conduct of a general commercial business, and not to prepare for the commencement of such a business or for the organization of a corporation, and that the trial court below should have instructed the jury that the defendants were individually liable for that portion of the plaintiff's claim which was incurred prior to December 22, 1902. Its failure to do so was a fatal error which necessitates a reversal of the judgments below.

In view of the conclusion which has now been reached, it is unnecessary to discuss at length or to determine other questions which are presented in this record. It is sufficient to say regarding the portion of the plaintiff's claim incurred subsequent to December 22, 1902, that while there is a conflict of authority upon the question whether or not incorporators or stockholders remain personally liable after the filing of articles in one office only where the statute requires them to be filed in two offices as a condition of incorporation or of the commencement of business (Mokelumne Hill Canal & Mining Co. v. Woodbury, 14 Cal. 265, 267), the statute under which this case arose was brought into the Indian Territory from the state of Arkansas, and the Supreme Court of that state had held, before it was adopted in the Indian Territory, that such corporators or stockholders remain individually liable under this statute unless and until their articles of incorporation are filed in both offices. Garnett v. Richardson, 35 Ark. 144. * * *

The judgments of the courts below must be reversed, and the case must be remanded to the proper court for a new trial; and it is so ordered.

INTER-OCEAN NEWSPAPER CO. v. ROBERTSON.

Supreme Court of Illinois, 1920. 296 Ill. 92, 129 N.E. 523.

Action by the Inter-Ocean Newspaper Company against John R. Robertson. Judgment for defendant was reversed by the Appellate Court, and defendant brings error. Judgment of Appellate Court reversed, and judgment of municipal court affirmed.

FARMER, J. This action was brought in the municipal court of Chicago by defendant in error against plaintiff in error, who was an officer and stockholder in the Chicago Real Estate Show Company, doing business as a corporation. The amended claim alleged the general manager of the Chicago Real Estate Show Company contracted with the Inter-Ocean Newspaper Company to publish certain advertising for it, which was published, and that $1,047.37 of the contract price had not been paid. The liability for the debt sued for is based on the claim that the Chicago Real Estate Show Company had not complied with section 4 of the corporation statute (Starr & C. Ann. St.1896, c. 32), requiring a corporation to file a certificate of complete organization in the office of the recorder of deeds, and the shareholders were for that reason copartners and liable as such to creditors. It is not disputed that the Chicago Real Estate Show Company applied for a charter as a corporation, that all the requirements of the statute precedent to the issuing to it of a final certificate of organization were complied with, that such final certificate was issued to it by the secretary of state, and that it proceeded to do business as a corporation, and was so doing business when the contract for advertising was made with the Inter-Ocean Newspaper Company. It neglected, however, to file its certificate of complete organization with the recorder of deeds. The affidavit of defense was that the Chicago

Real Estate Show Company was a de facto corporation at the time it made the contract for advertising with the Inter-Ocean Newspaper Company, and that said newspaper company made the contract with it on its credit as a corporation, and not with the stockholders or any of them. In 1911, after the cause of action accrued, the Chicago Real Estate Show Company was adjudged a bankrupt and insolvent. This suit was then brought against the stockholders, none of whom were served except plaintiff in error, to charge them with liability as copartners because the corporation had not completed its organization by filing the certificate in the recorder's office. * * *

The principal and important questions presented for decision are whether the Chicago Real Estate Show Company was a de facto corporation, and whether the stockholders in such a corporation are liable as partners to creditors.

All the requirements of the statute were complied with for the organization of the Chicago Real Estate Show Company as a corporation, and the secretary of state issued to it a certificate of complete organization January 31, 1911. A resolution was adopted, instructing the secretary of the corporation to file the charter or certificate of complete organization for record in accordance with the statute. He neglected to do that, and for that reason it is sought to charge the stockholders with liability as partners. By section 4 of chapter 32 of our statutes, where the provisions necessary to the organization of a corporation have been complied with, the secretary of state shall issue a certificate of complete organization of the corporation—

"and the same shall be recorded in a book for that purpose, in the office of the recorder of deeds of the county where the principal office of such company is located. Upon the recording of the said copy, the corporation shall be deemed fully organized and may proceed to business."

The first question to determine is whether the Chicago Real Estate Show Company was a corporation de facto. The essential conditions for the existence of a de facto corporation are a valid law under which it may be organized, an attempt in good faith to organize under that law, a colorable or apparent compliance with the law, and user of the corporate powers. Under decisions in this state and other jurisdictions, some of which we cite, the Chicago Real Estate Show Company was a corporation de facto, notwithstanding it neglected to file its final certificate of complete organization for record. Marshall v. Keach, 227 Ill. 35, 81 N.E. 29, 118 Am.St.Rep. 247, 10 Ann.Cas. 164; Gillette v. Aurora Railways Co., 228 Ill. 261, 81 N.E. 1005; Bushnell v. Consolidated Ice Machine Co., 138 Ill. 67, 27 N.E. 596; Tulare Irrigation District v. Shepard, 185 U.S. 1, 22 S.Ct. 531, 46 L.Ed. 773.

Whether members and stockholders of a de facto corporation, as distinguished from a de jure corporation, are protected from liability to creditors as partners, the decisions are not in entire accord, but the great weight of the authorities hold they are not liable, in the absence of a statute making them so liable. That the stockholders of a de facto corporation, where the members in good faith supposed they were legally incorporated under a valid law authorizing such

incorporation and honestly transacted business as a corporation, should not, in the absence of a positive statutory mandate, be treated and considered as partners as to persons dealing with it as a corporation seems to be absolutely sound. Some expressions used in Loverin v. McLaughlin, 161 Ill. 417, 44 N.E. 99, contrary to that rule and contrary to the great weight of authority, have been substantially repeated in a few subsequent cases, which has caused some doubt and uncertainty, but in none of the cases was the precise question here presented involved for decision. Loverin v. McLaughlin was an action against directors to establish liability against them under section 18 for failing to file for record the certificate of complete organization. The suit was to enforce a purely statutory liability, and did not involve the question of the liability of stockholders as partners at common law. In subsequent cases, where the language of the opinion in Loverin v. McLaughlin was in substance repeated, the action was to enforce a statutory liability against the officers, directors, and agents of the corporation. We do not therefore regard the question in this case as having been determined by this court. The rule is general that stockholders of a corporation are not personally liable at common law to creditors, and individual liability must be created by statute. Golden v. Cervenka, 278 Ill. 409, 116 N.E. 273; Terry v. Little, 101 U.S. 216, 25 L.Ed. 864. And this rule applies to de facto corporations. 1 Cook on Corporations (5th Ed.) § 234. * * *

Cook, in his work on Corporations (vol. 1 [5th Ed.] § 234), says that the great weight of authority has established clearly that the stockholders of a de facto corporation cannot be held liable as partners even though there have been irregularities, omissions, or mistakes in incorporating. The author expresses the view that this is reasonable and just; that parties who dealt with the company as a corporation should not be allowed to claim more than they originally bargained for, and hold the stockholders personally. He says the rule is established beyond reasonable doubt. In our opinion a contrary rule would be far-reaching in its consequences, and often lead to great injustice and hardship to innocent stockholders. It is by no means always practicable for purchasers of stock to examine every step taken in the organization of the corporation, and to hold them individually liable for its debts seems contrary to reason and justice, where there had been no fraud, but an honest effort had been made to effect a legal organization, and both the incorporators and stockholders in good faith believed the corporation legal, but some mistake or omission had been made such as here—neglect to file the final certificate of its complete organization for record.

Section 18 of our statute on corporations makes an officer, agent, or board of directors of a pretended corporation, who assume to exercise corporate powers without complying with the provisions of the statute, liable for debts contracted by them in the name of such corporation, but there is no statutory enactment making the stockholders liable in such case. In the absence of an express statute declaring such liability, we hold, in harmony with the great weight of authority, such liability does not exist. This conclusion makes un-

necessary the discussion of other questions raised and discussed in the briefs of counsel.

The judgment of the Appellate Court is reversed, and the judgment of the municipal court affirmed.

FRAWLEY v. TENAFLY TRANSPORTATION COMPANY.

Court of Errors and Appeals of New Jersey, 1921. 95 N.J.L. 405, 113 A. 242.

Separate actions by Teresa C. Frawley, individually and as administratrix of the estate of John F. Frawley, deceased, and of Vincent C. Frawley, deceased, against the Tenafly Transportation Company. Judgment for plaintiff in each case, and defendant appeals. Affirmed.

WALKER, CH. This is an appeal from each of three judgments in the Supreme Court recovered by the above-named plaintiff in three actions at law brought in the Supreme Court tried at the Bergen circuit before Cutler, J., and a jury. The cases, which arose out of the same accident, were tried together and involve common questions of law and fact. All of the questions raised on these appeals apply equally and the same to each of the three cases, were argued together, and will be so decided.

The facts appearing from the evidence are as follows: On April 25, 1919, the plaintiff Teresa C. Frawley, John F. Frawley, her husband, and Vincent C. Frawley, her son, were passengers in a jitney bus which collided with another jitney bus on Jay street in the borough of Tenafly, and in the collision each of the persons named sustained serious injuries, as a result of which John F. Frawley and Vincent C. Frawley died, and the three suits were instituted by Teresa C. Frawley individually for personal injuries sustained by her, one by the same Teresa C. Frawley as administratrix ad prosequendum of her deceased husband's estate, and one by the same Teresa C. Frawley as administratrix ad prosequendum of her deceased son's estate. Both of the jitney busses which figure in the accident had the same ownership, but in whom the title was vested or who employed the chauffeurs of the busses at the time of the accident are questions which were submitted to the trial court and are involved in this appeal. The defendant-appellant in his brief admits that the evidence establishes that one or both of the chauffeurs of the jitney busses at the time of the accident was, or were, negligent, and that such negligence was the proximate cause of the plaintiff's and her intestates' injuries. The three suits were originally against the defendant-appellant as a corporation, Harry Sabin, Martin M. Rothbart, Ernest Capitani and David Shiffman, as copartners, jointly and severally as individuals doing business under the name of Tenafly Transportation Company. The defendant company denied that it was a corporation on April 25, 1919, the date of the accident, denied that it was the owner of the busses in question, and denied its negligence, or the negligence of its servants or employés. It pleaded affirmatively that it was not a corporation on April 25, 1919, and that it did not own or operate, by its servants or otherwise, the jitney busses referred to,

and that its certificate of incorporation was filed with the secretary of state on April 29, 1919, having been recorded in the Bergen county clerk's office on April 26, 1919. These facts as to recording and filing of the certificate of incorporation were proved. Therefore, in order to recover, the plaintiff-respondent was required to show that the defendant company was a de facto corporation when the accident occurred, and was at that time the owner of the busses and the employer of the chauffeurs who operated them.

When the testimony was all in and the case rested, a motion was made for a nonsuit on behalf of the defendant company, upon the ground that its corporate existence at the time of the accident had not been proved, and upon the further ground that the ownership and operation of the busses at that time had not been proved. This motion was denied. * * *

On April 2, 1919, the busses in question were owned by the New Jersey Transportation Company, and on that day were sold to the four individuals above named. They commenced the operation of the busses in their business. On April 9, 1919, they applied to the borough of Tenafly in the name of the Tenafly Transportation Company, Incorporated, for an owner's license for the two busses in question, and filed with the borough an insurance policy in the name of the corporation, pursuant to the provisions of a borough ordinance, agreeing therein to operate the busses in strict conformity with the provisions of the ordinance. This application was granted on April 10, 1919. On April 11th they applied for and obtained from the authorities at Camp Merritt a license to operate the busses at the camp in the name of Tenafly Transportation Company, representing it as a corporation. On April 23, 1919, Rothbart, Shiffman, and Capitani signed and sealed a certificate of incorporation of the "Tenafly Transportation Company." This certificate was received in the Bergen county clerk's office on April 26, 1919, and there recorded. It was filed in the office of the secretary of state on April 29, 1919. On April 23, 1919, the date on which the certificate of incorporation was signed, Rothbart, Shiffman and Capitani made and executed to the "Tenafly Transportation Company, a corporation," for the consideration therein expressed, a bill of sale for ten busses described by numbers in a schedule annexed, including the two in question. The bill of sale ran to the corporation, its successors and assigns. These three men intended to form a corporation. The first certificate drawn for them was not executed because they changed their minds about the amount of capital stock. The second certificate, the one executed April 23, was drawn from instructions previously given by the three men. It was sent to them by counsel with directions to have it executed, which they did. It was returned to counsel on or about April 24, 1919, and on April 25 he mailed it to the Bergen county clerk, who recorded it and in a day or so returned it to counsel, and he then on or about April 27, mailed it to the secretary of state for filing. On April 25, 1919, the day of the accident, and previously the company had an office for the transaction of business in the borough of Tenafly, where a stenographer and bookkeeper were employed. Drivers of the two cars in question were employed

and paid with money contained in envelopes on which was printed "Tenafly Transportation Company, Incorporated." There was also a garage connected with the office, at which the cars were kept, and Rothbart, one of the incorporators, was acting as president of the corporation, by agreement with the other two incorporators. The defendants did not testify, and there is no affirmative evidence that they did business as a partnership or as individuals in the name of the Tenafly Transportation Company or otherwise. It is noticeable that the company was sometimes called "Tenafly Transportation Company, Incorporated," and sometimes "Tenafly Transportation Company"; *but this is unimportant* except to show that the three associates were bent upon having their company incorporated and to have it known as a corporation. It was, as already observed, actually incorporated as "Tenafly Transportation Company."

The grounds of appeal, which are the same in each case, are: (1) Because the court failed and refused to grant the motion for nonsuit made by the defendant at the close of the plaintiff's case; (2) because the court failed and declined to direct a verdict for the defendant, Tenafly Transportation Company, Incorporated, in accordance with the motion of the defendant at the close of the evidence in the trial of the case. The third, fourth, and seventh grounds of appeal are abandoned, and appear to be covered in the fifth and sixth grounds. The latter two pertain to the charge of the trial judge.

As to the question of de facto corporation, which is the principal ground involved in the motion to nonsuit and direct a verdict: By our act concerning corporations (Revision 1896, Comp.Stat. p. 1604, § 10), it is provided that, upon making the certificate of incorporation and causing the same to be recorded in the office of the county clerk and filed in the office of the secretary of state, the persons so associated, their successors and assigns, shall from the date of such filing be and constitute a body corporate. It is argued from this that the corporation defendant was not a body corporate on the day of the accident, because its certificate was not recorded in the county clerk's office until the day afterward, and not filed in the secretary of state's office until four days afterward. The answer is that it was nevertheless a de facto corporation. * * *

In McCarter v. Ketcham, 72 N.J.L. 247, 62 A. 693, it appeared that on a day while the earlier corporation act was in force certain persons signed a certificate of incorporation, held the first meeting, elected officers, and did business. The certificate was filed in the county clerk's office, but was never filed in the secretary of state's office; and yet this court held (72 N.J.L. at page 253, 62 A. at page 695):

"The company was a fully organized, active corporation de facto. It needed only the filing of its certificate in the office of the secretary of state to be a corporation de jure. When the corporation purchased from Holloway property which Holloway's creditors might reach, the rights of outside persons intervened, and the original stockholders and incorporators could not end the corporation by agreement among themselves to abandon the enterprise or by destroying the certificate

of incorporation. Bibb v. Hall, 101 Ala. 79, 14 So. 98; Aultman v. Waddle, 40 Kan. 195, 19 P. 730."

And this in the face of the statute in existence at the time of the decision of the Vanneman Case, which, as seen, provided that the company should become incorporated upon making, recording, and filing its certificate.

In Belvidere Water Co. v. Belvidere, 82 N.J.L. 601, it was held at page 603, 83 A. 241, at page 242:

"The question, therefore, is whether this action is maintainable in the name of the Belvidere Water Company. This depends, not upon the de jure, but upon the de facto, existence of such a corporation at the time suit was brought."

The only remaining question on this score is as to whether the facts in evidence justified the jury in finding the corporation defendant liable, and their verdict against the defendant corporation amounted to such finding. It included a finding that the three individual defendants had attempted bona fide to form a corporation, and that they had likewise done acts which amounted to the exercise of corporate powers. There was evidence from which the jury could draw these conclusions, and it is settled law that on appeal to this court, if there be any evidence warranting the finding of facts in the court below, its judgment on that score will be sustained. The bill of sale for the busses in question made by the individual defendants to the defendant company, and their operation by that concern as a de facto corporation, dispose of the contention that there was no proof to show ownership of the machines by the company. Therefore the overruling of the motions to nonsuit and direct a verdict was right. * * *

The views above expressed lead to an affirmance of the three judgments under review.

THIES v. WEIBLE et al. (FARMERS' UNION LIVE STOCK CREDIT ASSOCIATION, Intervener).

Supreme Court of Nebraska, 1934. 126 Neb. 720, 254 N.W. 420.

Action by Louis Thies against Fred W. Weible and others, wherein the Farmers' Union Live Stock Credit Association intervened. From an adverse judgment, the intervener appeals.

Judgment reversed, and cause remanded, with directions.

[Chattel mortgage on cattle issued by corporation which in fact never existed, was levied upon. Question whether it was good as between the parties.]

HASTINGS, DISTRICT JUDGE. * * * It is claimed by appellee that the chattel mortgage was void between the parties for the following reasons: (1) That the Weible Mercantile Company never had any existence as a corporation; (2) that the description of the cattle in the mortgage as to the cattle levied upon was insufficient; and (3) that the Weible Mercantile Company was not the owner of the cattle at the time of the execution of the mortgage. It is urged by appellee that the Weible Mercantile Company never had any existence as a

corporation, for the reason that some of the incorporators and others, who are stockholders therein, are infants. The answer, in effect, admits a colorable attempt on the part of the alleged incorporators to organize a corporation. The record shows that articles of incorporation, duly signed and acknowledged by the corporators, were adopted by the Weible Mercantile Company on December 3, 1927, and filed and recorded in the office of the county clerk of Wayne county on December 7, 1927, and also that such articles were filed and recorded in the office of the secretary of state on December 9, 1927. The Weible Mercantile Company, since the filing of its articles of incorporation, has continuously carried on and transacted the business of buying and selling live stock, grain and feed, and groceries, as provided for in its articles of incorporation. It has elected officers to carry on the said business, adopted and used a corporate seal, and during all of said time the judgment debtor, Fred W. Weible, has been the managing officer and secretary thereof. Furthermore, it has made and published statements as to its financial condition.

Section 24-201, Comp.St.1929, provides that any number of persons may be associated and incorporated for the transaction of any lawful business, and infants are not expressly excluded by the statute as persons who may not associate themselves with others in forming corporations. We do not find it necessary in this case to decide whether they may do so or not. Although a de jure corporation may not have been formed, owing to the incapacity of some of the corporators, we are convinced that there was a corporation de facto whose existence cannot be questioned by appellee in this action. The general rule is: "When persons assume to act as a body, and are permitted by the acquiescence of the public and the state to act as if they were legally a particular kind of corporation, for the organization, existence, and continuance of which there is express recognition by the general law, such a body of persons is a corporation de facto, although the particular persons thus exercising the franchise of being a corporation may have been ineligible and incapacitated by the law to do so. This is on the same principle on which it is held that a person may be a de facto officer, although ineligible." 1 Clark and Marshall, Private Corporations, 260, par. g. See 1 Fletcher, Cyclopedia Corporations, 595, § 292; American Salt Co. v. Heidenheimer, 80 Tex. 344, 15 S.W. 1038, 26 Am.St.Rep. 743.

We have frequently held that where the law authorizes a corporation and there has been an attempt in good faith to organize, and the requirements of the statute have been colorably complied with and corporate functions thereunder exercised, there exists a corporation de facto which ordinarily cannot be called into question collaterally. [Citing cases.]

The reason a collateral attack by a third person will not avail against a corporation de facto is that, if the rights and franchises have been usurped, they are the rights and franchises of the state, and it alone can challenge the validity of the franchise. Until such interposition, the public may treat those in possession and exercising corporate powers under color of law as doing so rightfully. The rule

is in the interest of the public and is essential to the safety of business transactions with corporations. It would produce disorder and confusion, embarrass and endanger the rights and interests of all dealing with the association, if the legality of its existence could be drawn into question in every suit in which it is a party or in which rights were involved springing out of its corporate existence. 1 Fletcher, Cyclopedia Corporations, 545, § 276; Duggan v. Colorado Mortgage & Investment Co., 11 Colo. 113, 17 P. 105; 14 C.J. 204–207; 7 R.C.L. 60, § 42; 1 Clark and Marshall, Private Corporations, 241, § 82.

Speaking of an attempt to question the legal existence of a corporation, this court has said in Haas v. Bank of Commerce, supra: "It would be intolerable to permit, in any civil action to which such a body was a party, an inquiry into the legal right to exercise corporate functions,—a right which it is for the state alone to question in appropriate proceedings for that purpose. On this there is a substantial unanimity in the authorities."

The attempt is made in this case, although the corporation is not even a party to the action. "A mortgage made by or to a corporation de facto is as valid as if it were made by or to a corporation de jure, and cannot be attacked on the ground of want of incorporation, either by the mortgagor or by persons claiming under him or it, or by third persons." 1 Clark and Marshall, Private Corporations, 234, § 3.

In this case the appellant dealt with the Weible Mercantile Company in good faith, believing that it was a corporation, and was entitled to assume that the corporation rightfully possessed corporate powers. The appellee, having acquired no right or interest in the mortgaged property by reason of the levy, will not be permitted to make a collateral attack on the existence of the Weible Mercantile Company as a corporation. * * *

The trial court erred in adjudging that the sheriff pay the fund in question to the appellee. The judgment is reversed and the cause remanded with directions to enter judgment for the appellant, and directing that payment of the fund in question be made to appellant.

Reversed.

TRUSTEES OF EAST NORWAY LAKE NORWEGIAN EVANGELICAL LUTHERAN CHURCH and others v. FROISLIE and another.

Supreme Court of Minnesota, 1887. 37 Minn. 447, 35 N.W. 260.

MITCHELL, J. On the trial of this case much irrelevant and immaterial evidence was introduced or offered, and almost all of the evidence offered by either party was objected to by the other. And when the case comes here on appeal, we are confronted with the formidable number of 42 assignments of error. But when this mass of rubbish is removed, the material facts are found to be comparatively simple, and the legal questions involved very few.

The action is ejectment. The common source of title under which both parties claim is a religious society incorporated under title 4, c. 37, Gen.St., under the name of "The Trustees of the Norwegian Evangelical Lutheran Church of Norway Lake, Kandiyohi county, Minnesota," and called on the trial the "Old Society." This society acquired title of the premises in dispute by deed from Hanson and Heden, and used and occupied them as a parsonage or residence for their pastor. They employed as pastor one Markus, who received for his services as such a certain cash salary, and the use of this parsonage as a residence. He went into possession in October, 1870, and occupied it under this arrangement until the division of the society hereinafter referred to. In 1877 the members of the society having determined to divide, two new societies were organized, or attempted to be organized, under the statute. As appears from their respective certificates of incorporation, the name adopted by one of them was "The Trustees of the East Norway Lake Norwegian Evangelical Lutheran Church of Kandiyohi county, Minnesota," and by the other, "The Trustees of the West Norway Lake Evangelical Lutheran Church of the town of Norway Lake, Kandiyohi county, Minnesota." *All* of the members of the old society went into one or the other of these two, and thereafter the organization of the old society appears to have been abandoned, except for the purpose of closing up their business, and disposing of their property. Both of these new societies have ever since been in the exercise of all the usual powers and functions of religious corporations. They continued, however, to worship together in the old church until as late as June, 1878. At a meeting of the old society held June 28, 1878, it being desired to transfer their property to the two new organizations, but the description of a part of it in their deed from Hanson and Heden being considered not sufficiently definite, it was thought that the best way to correct this and accomplish the desired object was to reconvey to Hanson and Heden, and have them convey to the new societies. The society thereupon adopted a resolution authorizing their trustees to convey to Hanson and Heden, and requiring the latter then to convey to the two new societies. In pursuance of this the trustees of the old society conveyed to Hanson and Heden, and they in turn to plaintiff. This is plaintiffs' title. * * *

Defendants, however, attack plaintiffs' title. They claim that they were never legally organized, and hence were incapable of taking or holding property. The points made in support of this contention are that the meetings at which the organizations were attempted to be made were not held after sufficient notice; that the certificates of incorporation were not properly executed, acknowledged, or recorded, etc.; and that chapter 193, Sp.Laws 1878, purporting to legalize the organizations, is unconstitutional. Under the view we take of the case it is wholly unnecessary to consider any of these questions. The plaintiffs are at least corporations *de facto*. Such a corporation, at least where there is a law under which a corporation might have been legally formed with such power, is capable of taking and holding property as grantee, as well as a corporation *de jure*, and convey-

ances to it are valid as to all the world, except the state in proceedings in *quo warranto,* or other direct proceedings to inquire into its right to exercise corporate franchises. And in an action by it to recover such property, no private person will be allowed to inquire collaterally into the regularity of its organization. This rule is not founded upon any principle of estoppel, as is sometimes assumed, but upon the broader principles of common justice and public policy. It would be unjust and intolerable if, under such circumstances, every interloper and intruder were allowed thus to take advantage of every informality or irregularity of organization. * * *

Judgment affirmed.

ENTERPRISE ENTITY: DISREGARD OF THE CORPORATE FICTION

NOTE

"DISREGARD OF THE CORPORATE FICTION"

One of the most rapidly growing sectors of corporation law is a division which deals with what is called "disregard of the corporate fiction". There has been no careful study of this subject resulting in general agreement systematizing and classifying this branch of the law. Student and professor alike have a clear opportunity to do independent thinking, which is more than likely to influence the further development of the law itself.

By doctrine, the corporation was a fictitious personality with independent entity. Yet it early developed that under certain circumstances this entity was lost, or was disregarded by the courts under certain circumstances. If the courts could attach the incidents of corporate entity to an imperfect corporation ("de facto corporations"), they could also decline to give attributes of entity and personality to perfectly organized corporations. This was called "disregard of the corporate fiction".

Yet under this general heading were lumped a whole series of disparate situations. Thus, corporate entity could be disregarded (lost?) where the corporation, though perfectly formed, so mingled its assets, accounts and operations with those of others as to become indistinguishable as an enterprise. This frequently occurs between a parent corporation and its subsidiary corporation, and sometimes appears as a doctrine under "Parent and Subsidiary", but it is clear that the same result would occur if an individual owner of the stock of a corporation mingled the assets and accounts and so forth with his own.

Where the corporation is organized as a mere endeavor to screen the associates in doing a forbidden act, the courts can disregard the entity. A famous case was the so-called Northern Securities case (193 U.S. 197, 24 S.Ct. 436), in which an attempt was made to escape the application of the anti-trust laws to railroads by forming a holding company which was to take over a controlling interest of the securities of the railroads designed to be united. It was held that the court could look through the fictitious entity of the personality and determine that there was really an agreement between the component railroads. Again, where the enterprise, though incorporated, has been outfitted with such inadequate capital and assets that it plainly operates not on its own financial bottom but on the bottom of someone else, the courts disregard the corporate entity at least to the extent of attaching the liabilities of the corporation to the person or the corporation really furnishing the basic assets and operation.

Again, where a parent, though supplying a subsidiary corporation with assets, obtrudes itself into the management of the subsidiary and manages the affairs of

the subsidiary not in the interests of the subsidiary corporation, but in the interest of the parent, the courts likewise look through the corporate entity. Naturally where the subsidiary is wholly owned, there is no outsider to complain, so long as creditors are paid. But where there are outside stockholders of a subsidiary, the courts, having disregarded the entity, may then endeavor to repair the wrong to the outsider. One such application of this is the famous Deep Rock case (Taylor et al. v. Standard Gas & Electric Company et al., 306 U.S. 307, 59 S.Ct. 543, post) in which the courts having ascertained that the subsidiary had been managed, not as an independent enterprise standing on its own bottom, but as an integral part of the parent's operations and for its benefit, subordinated a debt due to the parent from the subsidiary to the prior claims of the preferred stockholders of the subsidiary.

The generalizations from these cases are anything but satisfactory. It is sometimes said that the corporate entity will be disregarded where necessary "to do equity", the length of the Chancellor's foot being apparently the only test of equity; and in an extreme case (Anderson v. Abbott, 321 U.S. 804, 64 S.Ct. 845, post), where necessary to give effect to public policy—which is subject to the familiar comment that "public policy" can be a very wild horse indeed unless it is clearly defined.

The editors submit as a possible analysis, that:

1. "Disregard of the corporate fiction" covers two distinct situations, namely,
   (a) sheer loss of corporate entity because the fictitious corporate entity has lost factual connection with the entity of the enterprise actually being carried on (the cases of mingling of assets and accounts are typical in this field); and
   (b) cases in which conduct contrary to settled public policy or statutory rule, or conduct constituting a wrong to any group of parties requires disregarding the corporate entity for the purpose of working out a remedy. The remedy is adapted to the wrong done and the reparation required and may be
      (i) subordination of the claims of the parent to the claims of third parties in a subsidiary (the Deep Rock case doctrine);
      (ii) attachment of the liabilities of the subsidiary to the assets of the parent as may be equitable to the assets of the combined parent-subsidiary taken together;
      (iii) required payment from the parent to the subsidiary, using the subsidiary as the vehicle through which the various classes of its creditors and stockholders may be placed in a position in which they would have been had the condemned conduct not occurred;
      (iv) simple nullification of any effect of the intervention of the subsidiary and judgment of the transaction as though the persons composing the subsidiary had acted as such (the cases disregarding corporation fiction for violation of criminal statute, public policy, etc.). Naturally the types of remedy will ramify with the wrong to be remedied.

The words "parent" and "subsidiary" have been used frequently in this note because this is the familiar, almost typical form in which the problem comes up. Plainly the fact that the parent is a corporation is not essential.

The following are sources of cases evidencing the principal fields in which the corporate entity has been disregarded.

TELIS v. TELIS et al.

Court of Errors and Appeals of New Jersey, 1942. 132 N.J.Eq. 25, 26 A.2d 249.

Suit by Sophie Telis against Jacob Telis and Telise's Bargain Store to attach an inchoate right of dower to real estate held by corporate defendant. From an adverse decree, complainant appeals.

Reversed and remanded.

PERSKIE, JUSTICE. The question for decision in this cause, between husband and wife, is whether the Advisory Master erred in advising a decree dismissing that part of the wife's bill which sought to attach an inchoate right of dower to certain real estate, legal title to which was in a corporation formed by the husband for the alleged purpose of defrauding the wife and depriving her of her right of dower in and to the realty.

The bill of complaint filed by the wife sets forth two causes of action. The first cause of action was for support and maintenance. After hearing, an order was entered directing the payment by the husband of $15 a week to the wife. This order is not here challenged.

The second cause of action was predicated upon allegations that the husband caused real estate located at 223 South Connecticut Avenue, in Atlantic City, to be purchased in the name of a corporation owned and wholly controlled by him, solely for the purpose of defrauding his wife of her dower right in and to that real estate. Although at the hearing the husband offered to convey the property to his wife, he apparently suffered a change of heart and refused to carry out his promise. The Advisory Master then advised a decree dismissing this cause of action upon the ground that the proofs failed to disclose that any fraud was perpetrated. The wife has appealed from this decree.

Notwithstanding that there is considerable dispute over the legal effect of the proofs, the basic facts are, in the main, uncontradicted. The parties were married in New York in 1921. Two children were born of the marriage, a boy now nineteen years old and a girl now twelve years of age. The former is an invalid as a result of paralysis. Shortly after the marriage, the husband commenced periodically to disappear, on several occasions taking European trips. The husband deserted his wife in New York in 1933 and did not reappear until April of 1937 when he called upon her to take her to Atlantic City to show her a store he was operating there. During the interval of his desertion, he failed to provide for his wife and children. From 1937, he contributed $40 a month for their support during the winter months. In the summer months they lived in one room, provided by the husband, in a rooming house in Atlantic City. They largely depended for sustenance, raiment and medical care upon the efforts of the wife and the charity of her friends and relatives.

On March 20, 1939, the husband formed a corporation called Telise's Bargain Store and thereafter operated his business under that corporate name. The certificate of incorporation was filed in the county

clerk's office on March 22, 1939 but it does not appear when, if ever, the certificate was filed with the Secretary of State. One hundred shares of stock were purportedly issued, 98 to the husband, one to his son and one to Sarah Steinmetz. These shares, however, were never delivered to the owners but were retained by the husband, respondent herein. Approximately eight months later, on November 6, 1939, the corporation entered into an agreement to purchase the aforesaid property, and on December 28, 1939 a deed to this property was delivered to the corporation. The purchase price was $4,400 of which sum respondent paid in cash $1,331.41, the balance, exclusive of settlement charges, being secured by a purchase money mortgage apparently executed by the corporation. It is against this property in the name of "Telise's Bargain Store" that the wife sought to attach her inchoate right of dower. It appears that the corporation is about to sell this property but the parties have stipulated that in the event of sale the proceeds will be left in escrow pending the outcome of this appeal. * * *

Notwithstanding all this, we are of the mind that the relief sought should be granted upon the ground that respondent is in fact the owner of the realty and, therefore, his wife is entitled to her inchoate right of dower therein. For the wife is not only entitled to dower in real estate held to the use of her husband but also in real estate "whereof" the "husband" himself was seized of an estate of inheritance during coverture. N.J.S.A. 3:37–1. If under the dower act a wife's dower right may be secured against one who holds to the use of her husband, in reason and justice she should, and we hold that she is, entitled to the same relief when, as here, the husband factually is the owner of the real estate, irrespective of the corporate form employed to veil that ownership.

The right of our courts, in a proper case, to pierce the corporate veil can not be gainsaid. The common exercise of that right does not trench upon the general principle that a "corporation is not an individual even if the individual owned all the stock of the corporation." White v. Evans, 117 N.J.Eq. 1, 3, 174 A. 731, 732; Jennings v. Studebaker Sales Corp., 112 N.J.L. 399, 170 A. 626; Jackson v. Hooper, 76 N.J.Eq. 592, 598, et seq., 75 A. 568, 27 L.R.A.,N.S., 658. Nor does it trench upon the established principle that the legality of the existence of a de facto corporation may be attacked only by the state in a direct proceeding, by information in the nature of quo warranto proceedings. Cf. St. John The Baptist, etc., Church v. Gengor, 121 N.J.Eq. 349, 357, 189 A. 113; Elizabethtown Gas-Light Co. v. Green, 46 N.J.Eq. 118, 18 A. 844, affirmed 49 N.J.Eq. 329, 24 A. 560. Rather is the common exercise of the right to pierce the corporate veil deeply and firmly rooted in the principle that our courts do not permit the doctrine of corporate entity to be used for the purpose of defeating justice.

The proofs in the case at bar clearly satisfy us that the respondent The corporation was never perfected; respondent held all of the stock notwithstanding that the two shares were in the name of others; and not Telise's Bargain Store, the corporation, owns the real estate.

there never was a formal meeting; no by-laws were ever adopted and corporate funds were intermingled with respondent's funds and used in payment of respondent's personal obligations. Form and not substance was effected. These and all other circumstances in the case entirely convince us that the corporate creation was, and its existence is, a mere sham, a mere subterfuge, a mere instrumentality employed for concealing the truth and, therefore, in the equitable sense, fraudulent.

The denial of the wife's statutory right of dower, under the circumstances of the case at bar, defeated the relief to which she was justly entitled and, therefore, can not be permitted. She is entitled to have her statutory right of dower in and to the premises in question secured to her. We so hold. * * *

The decree is reversed with costs.

BERKEY v. THIRD AVENUE RAILWAY COMPANY.

Court of Appeals of New York, 1926. 244 N.Y. 84, 155 N.E. 58.

Actions by Minnie Best Berkey and Charles P. Berkey against the Third Avenue Railway Company. From an order of the Appellate Division (217 App.Div. 504, 217 N.Y.S. 156), reversing a judgment of the Trial Term, which dismissed complaints, and granting new trial, defendant appeals. Order reversed, and judgment of the Trial Term affirmed.

CARDOZO, J. The plaintiff boarded a street car at Fort Lee Ferry and One Hundred and Twenty-Fifth street on October 4, 1916, in order to go east on One Hundred and Twenty-Fifth street to Broadway, and thence south on Broadway to Columbia University at One Hundred and Seventeenth street. She was hurt in getting out of the car through the negligence of the motorman in charge of it. The franchise to operate a street railroad along the route traveled by the plaintiff belongs to the Forty-Second Street, Manhattanville & Saint Nicholas Avenue Railway Company (described for convenience as the Forty-Second Street Company), and no one else. Substantially all the stock of that company is owned by the Third Avenue Railway Company, the defendant, which has its own franchise along other streets and avenues. Stock ownership alone would be insufficient to charge the dominant company with liability for the torts of the subsidiary. Elenkrieg v. Siebrecht, 238 N.Y. 254, 144 N.E. 519, 34 A.L.R. 592; Stone v. Cleveland, C., C. & St. L. R. Co., 202 N.Y. 352, 95 N.E. 816, 35 L.R.A.,N.S., 770.

The theory of the action is that under the screen of this subsidiary and others, the defendant does in truth operate for itself the entire system of connected roads, and is thus liable for the torts of the consolidated enterprise. Chicago, M. & St. P. R. Co. v. Minneapolis Civic & Commerce Ass'n, 247 U.S. 490, 38 S.Ct. 553, 62 L.Ed. 1229; Davis v. Alexander, 269 U.S. 114, 46 S.Ct. 34, 70 L.Ed. 186. * * *

Liability of the parent has never been adjudged when the subsidiary has maintained so consistently and in so many ways as here

the separate organization that is the mark of a separate existence, and when the implication of a contract for unity of operation would be the implication of a contract for the commission of a crime.

The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it. We say at times that the corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterized as an "alias" or a "dummy." All this is well enough if the picturesqueness of the epithets does not lead us to forget that the essential term to be defined is the act of operation. Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent. Where control is less than this, we are remitted to the tests of honesty and justice. Ballantine, Parent and Subsidiary Corporations, 14 Cal.Law Review, 12, 18, 19, 20. The logical consistency of a juridical conception will indeed be sacrificed at times, when the sacrifice is essential to the end that some accepted public policy may be defended or upheld. This is so, for illustration, though agency in any proper sense is lacking, where the attempted separation between parent and subsidiary will work a fraud upon the law. Chicago, M. & St. P. R. Co. v. Minneapolis Civic & Commerce Ass'n, 247 U.S. 490, 38 S.Ct. 553, 62 L.Ed. 1229; United States v. Reading Co., 253 U.S. 26, 61, 63, 40 S.Ct. 425, 64 L.Ed. 760. At such times unity is ascribed to parts which, at least for many purposes, retain an independent life, for the reason that only thus can we overcome a perversion of the privilege to do business in a corporate form. We find in the case at hand neither agency on the one hand, nor, on the other, abuse to be corrected by the implication of a merger. On the contrary, merger might beget more abuses than it stifled. Statutes carefully framed for the protection, not merely of creditors, but of all who travel upon railroads, forbid the confusion of liabilities by extending operation over one route to operation on another. In such circumstances, we thwart the public policy of the state instead of defending or upholding it, when we ignore the separation between subsidiary and parent and treat the two as one.

The order of the Appellate Division should be reversed, and the judgment of the Trial Term affirmed with costs in the Appellate Division and in this court.

KEYSTONE MINING COMPANY v. GRAY (BITUMINOUS COAL PRODUCERS BOARD FOR DIST. NO. 1, Intervener).

Circuit Court of Appeals of the United States, Third Circuit, 1941. 120 F.2d 1.

Petition by the Keystone Mining Company to review and set aside an order of H. A. Gray, Director of the Bituminous Coal Division, Department of the Interior, United States of America, denying the petitioner's request for an order exempting it from the provisions of

section 4 and section 4-A of the Bituminous Coal Act of 1937, with respect to coal produced and disposed of by it, wherein the Bituminous Coal Producers Board for District No. 1 intervened.

Order of the Director affirmed.

BIGGS, CIRCUIT JUDGE.

The Facts.

The petitioner, Keystone Mining Company, is a corporation of the State of Pennsylvania, wholly owned and controlled by the Delaware, Lackawanna and Western Railroad Company. It has no funded indebtedness. It owns coal-mining properties in Pennsylvania and produces coal from its mines at cost for use in the locomotives of the Lackawanna Railroad Company. The petitioner has a board consisting of five directors who are elected by the vote of the stock held by the Lackawanna Railroad Company. Two of these directors are officials of the Lackawanna Railroad Company, being respectively general attorney and general superintendent. Keystone's treasurer is also the secretary-treasurer of the Lackawanna Railroad Company; its auditor is assistant to the Lackawanna Railroad Company's comptroller. The petitioner has an office at Scranton, Pennsylvania, which is furnished to it gratis by the Lackawanna Railroad Company. The coal company's books are maintained at Lackawanna Railroad Company's office at New York City.

The petitioner has absolute ownership of the coal properties, the mining equipment and accessories. It leases some parts of the properties to third persons. The title to the coal mined is retained by Keystone until it is loaded for shipment in cars at the tipples upon its property. The petitioner has a mining supply store which is managed by it. The Lackawanna Railroad Company does not supervise Keystone's operations. These operations are conducted by petitioner's general superintendent subject to the supervision of its president. These two officers are neither directors, officers, nor employees of the Lackawanna Railroad Company. Keystone's legal work is handled by its secretary who is not employed by the Lackawanna Railroad Company.

The petitioner employs about nine hundred men. Its superintendent hires and discharges them. He purchases all mining supplies and necessary equipment and bills them to petitioner. The coal company maintains its own bank account and pays its employees by checks drawn against this account. Its employees who are also employees of the Lackawanna Railroad Company receive salary checks from the petitioner which cover their services to it in so far as their services can be allocated to it. Charges capable of being allocated directly to Keystone are paid by it. Petitioner enters into collective bargaining contracts with a local of the United Mine Workers of America at Scranton and is also a member of an operators association. It assumes liability for all accidents which may happen to its employees, settles claims against it, using its own checks and vouchers for this purpose, and, being a self-insurer under the Pennsylvania Workmen's

Compensation Insurance Law, has deposited United States government bonds under a trust agreement in accordance with law.

Keystone pays its own federal, state and local taxes, files in its own name all the returns and reports required of it, including the reports required by the National Bituminous Coal Commission. * * *

Prior to 1934, when consolidated income tax returns were filed by the Lackawanna Railroad Company for itself and Keystone, the coal company delivered all of its coal to the railroad company at approximately the market price. Following the abolition of the consolidated income tax privilege that practice was abandoned. Prior to 1934, Keystone also declared dividends. These, however, never were actually paid to the Lackawanna Railroad Company, but were reflected in bookkeeping items by the two companies; that is to say, the coal company received credits upon the books of the railroad company to the extent of the dividends declared by Keystone. The general policies of the petitioner are established by consultation between its president and the president of the Lackawanna Railroad Company. * * *

The Agency Rule.

The agency rule is an instrumentality for piercing the veil of the corporate entity, a fiction oddly [4] employed to look through a fiction. The petitioner has cited on its brief a number of typical cases in which the agency rule has been applied. For example in Chicago, Milwaukee & St. Paul Railway Company v. Minneapolis Civic & Commerce Association, 247 U.S. 490, 500, 501, 38 S.Ct. 553, 62 L.Ed. 1229, the Supreme Court held that the Minneapolis Eastern Railway Company could not impose carrying charges distinct from those of its parent corporation simply because it was a separate legal entity. See also the opinion of Mr. Justice Holmes in Gulf Oil Corporation v. Lewellyn, 248 U.S. 71, 72, 39 S.Ct. 35, 63 L.Ed. 133.

In Hart Steel Company v. Railroad Supply Company, 244 U.S. 294, 298, 37 S.Ct. 506, 61 L.Ed. 1148, it was held that the agency rule might be asserted in a patent case to prevent the retrial of an issue previously adjudicated. In Southern Pacific Company v. Lowe, Jr., Collector, 247 U.S. 330, 337, 38 S.Ct. 540, 62 L.Ed. 1142, the rule was invoked to the end that dividends "constructively" received by way of bookkeeping items by a parent corporation from a wholly owned subsidiary should not be taxable to the parent. In Davis v. Alexander, 269 U.S. 114, 115, 46 S.Ct. 34, 70 L.Ed. 186, the Supreme Court disregarded the fiction of the corporate entity, holding that where one railroad company actually controls another and operates both lines as a single system, the dominant company would be held liable for injuries due to the negligence of the subsidiary company.

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[4] The word "oddly" is our tribute to the intricacy of the judicial mind. The captious person might inquire whether the piercing of the corporate veil was a fiction or whether the corporate veil, itself, was a fictitious veil. We think, however, that the coal producer is bent on rending its fictitious veil with a fictitious instrumentality.

Further citation of authorities upon the nature of the agency rule or explanation of circumstances under which the fiction of the corporate entity will be disregarded would be fruitless. A comprehensive summary of decisions upon this subject is contained in Majestic Co. v. Orpheum Circuit, 8 Cir., 21 F.2d 720, 724–725. We think we may say that the fiction of the corporate entity will be disregarded where it is used as an instrumentality to defeat the public convenience or to perpetrate fraud. As the converse to the ruling enunciated by the Supreme Court in Chicago, Milwaukee & St. Paul Ry. Co. v. Minneapolis Civic & Commerce Association, supra, we conclude that the agency rule should not be applied and that corporate entity should not be disregarded in order to avoid the effect of a regulatory statute enacted in the public interest. We think that where a remedial statute is involved the purpose of the legislation must be kept in view and that the agency rule should not be applied in derogation of the plain intention of the legislature. * * *

Conclusion.

For these reasons and with all respect to the able tribunals which have declared to the contrary, we deem the agency rule to be inapplicable and the coal company, not the railroad company, to be the producer of coal within the meaning of the act. It follows that the exemptions sought by the petitioner must be denied.

Accordingly the order of the Director is affirmed.

WEISSER et al. v. MURSAM SHOE CORPORATION et al.

Circuit Court of Appeals of the United States, Second Circuit, 1942. 127 F.2d 344.

Action by Rose Weisser and another against Mursam Shoe Corporation, Murray M. Rosenberg, Incorporated, Miles Shoes, Incorporated, Murray M. Rosenberg, and Samuel H. Rosenberg, to recover rent under a lease. From an order granting a motion for summary judgment made by the defendants Murray M. Rosenberg, Incorporated, Miles Shoes, Incorporated, Murray M. Rosenberg, and Samuel H. Rosenberg, and dismissing the complaint as to them, 40 F.Supp. 1007, the plaintiffs appeal.

Reversed and remanded.

Before AUGUSTUS N. HAND, CLARK, and FRANK, Circuit Judges.

FRANK, Circuit Judge. The issue before us is the extent to which stockholders and affiliated corporations are liable on a contract made by a so-called "leasehold" corporation.[1] The two individual defend-

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1 The general problem before us is extensively dealt with in Douglas and Shanks, Insulation from Liability through Subsidiary Corporations, 39 Yale L.J. (1929) 193; Powell, Parent and Subsidiary Corporations (1931). The pioneer studies of Wormser, Piercing the Veil of Corporate Entity, 12 Col.L.Rev. (1912) 496, and of Machen, Corporate Personality, 12 Harv.L.Rev. (1911) 253, 347, are still of interest.

Various facets of the problem have been recently discussed in Taylor v. Standard Gas & Electric Co., 306 U.S. 307, 618, 59 S.Ct. 543, 83 L.Ed. 669 and in Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281.

ants, Murray and Samuel Rosenberg, own substantially all of the capital stock of Murray M. Rosenberg, Inc., which was engaged in operating a chain of retail shoe stores. The shoes sold in these stores bore the name "Miles," a trade-name owned by Miles Shoes, Inc., also substantially owned by the individual defendants, and apparently used by Murray M. Rosenberg, Inc., under some undisclosed arrangement.

In 1926, Murray Rosenberg approached the plaintiffs to negotiate the terms of a lease of certain premises in Paterson, New Jersey. Their version of the negotiations is as follows: "When we had agreed upon the terms of the lease, Murray M. Rosenberg told us that the tenant was to be the Mursam Shoe Corporation. I asked him who was the Mursam Shoe Corporation. Murray M. Rosenberg represented to me that the name Mursam was an abbreviation for Murray and Samuel, and that he and his brother were the corporation and 'stood behind' the lease. He told us that the store to be opened at the leased premises by them, was to be part of the chain of stores which he and his brother were then operating. Relying upon these representations, the plaintiffs entered into a lease with Mursam for a term of fifteen years." The Mursam Shoe Corporation was organized by the Rosenbergs the day the lease was signed and sealed by the plaintiffs, and two days later it signed and sealed the lease as tenant. According to its books, the original capital investment in Mursam was $1; apart from paying legal and similar fees arising out of the organization of Mursam, the Rosenbergs paid nothing for their stock, and it does not appear that subsequently they made any contributions to capital. Mursam was, therefore, a corporation without assets. Its obligation under the lease was $10,000 annually, for the first five years, $11,000 for the next five and $12,000 for the last five years, or $165,000 for the entire term.

For fourteen years Mursam met its obligations on this lease. It was able to do so because of payments made to it by Murray M. Rosenberg, Inc., which occupied the leased premises under short term subleases. In March 1940, Murray M. Rosenberg, Inc., terminated the sublease then in effect (made February 1, 1939), which was of unspecified duration on a monthly basis, and vacated the premises. Mursam having no assets, this action for damages caused by breach of the lease by failing to pay rent was brought against the other individual and corporate defendants as well.

It is alleged that Mursam is only an instrumentality through which these other defendants carry on their chain store operations, and that it is necessary to pierce its corporate "veil" in order to prevent injustice and circumvent fraud. There is evidence that Mursam's corporate identity was often ignored by the other defendants themselves, and that funds were shifted about from one defendant to another without regard to formality and to suit their immediate convenience. Thus, the very first transaction under the lease was the payment of a $5,000 deposit by the personal check of Murray M. Rosenberg. Although this payment is asserted to be a loan to Mursam, its books are silent as to any arrangement with Murray M.

Rosenberg for the borrowing or repayment of this amount. For several years Murray M. Rosenberg, Inc., paid to Mursam the amount of the taxes on the property (which Mursam was required to pay by its lease with the plaintiffs), although no provision in the subleases required Murray M. Rosenberg, Inc., to pay these amounts. Rents due on a tobacco-stand on the premises which was sub-leased by Mursam to one Mourad Papas were, with a few exceptions, collected by Murray M. Rosenberg, Inc. Although by a surrender dated January 15, 1934, Murray M. Rosenberg, Inc., transferred title to the fixtures on the premises to Mursam, the fixtures were removed by Murray M. Rosenberg, Inc., when it vacated the store. Certainly Mursam was undercapitalized, and the payment of dividends and salaries soon relieved it of any surplus which it managed to accumulate by virtue of favorable subleases with Murray M. Rosenberg, Inc. For a substantial period Mursam lacked a bank account and books of account, and it never paid Murray M. Rosenberg, Inc., or Miles for accounting services rendered to it or for its use of their offices.

Enough of the facts have been stated to indicate that on a full trial it might be found that Mursam was only a tool of the other defendants, deliberately kept judgment-proof, to obtain the benefits of a lease with the plaintiffs without assuming any obligations. The plaintiffs allege that this was done fraudulently, in that Mursam was generally represented as being an integral part of their chain store operations and as having the same business and financial responsibility as the other defendants, so that the public was led to believe that dealing with Mursam was the same as dealing with them. The plaintiffs also state, in the language quoted above, that specific representations of these facts were made to them, and that they relied thereon. The defendants explain or deny many of the facts relied upon by the plaintiffs, but since this case comes up on motion for summary judgment,[2] we must give the plaintiffs the benefit of every doubt.

The trial judge granted the motion, saying that Wagner v. Manufacturers' Trust Co., 237 App.Div. 175, 261 N.Y.S. 136, 140, was controlling and that the complaint here is only an "artful attempt" to avoid the ruling of that case. In holding that New Jersey law is the same as New York, the court below was in error, but even if it were correct, we are not sure that the holding of the Wagner case disposes of the case at bar. There, on similar facts, the Appellate Division, affirmed without opinion by the Court of Appeals, 261 N.Y. 699, 185 N.E. 799, held that the Statute of Frauds prevented the substitution of a new party to the lease, and said:

"If, upon the allegations of this complaint, defendant were held equitably estopped from relying upon the statute of frauds, then in many cases a defendant might be impeded in obtaining the benefit of that statute. The courts would abound with cases where a plaintiff would claim that it might be more equitable to prevent the defendant from pleading and relying upon the statute of frauds, than to enforce that statute, and the statute would be, in large measure,

[2] By all defendants except Mursam.

nullified. Every litigant, of course, has as much right to rely upon that statute as upon any other legislative enactment and courts are not prone to deny its protection."

The opinion hardly comes to grips with the real issue in such cases as these, which the Supreme Court has said to be whether or not ownership of the subsidiary "is resorted to, not for the purpose of participating in the affairs of the corporation in which it is held in a manner normal and usual with stockholders, but for the purpose of making it a mere agent, or instrumentality or department of another company." United States v. Reading Co., 253 U.S. 26, 62, 63, 40 S.Ct. 425, 434, 64 L.Ed. 760.[3] If this is found as a fact,[4] courts have seldom found the Statute of Frauds an obstacle to the imposition of liability, since it does not prevent penetration through an alias to hold the "real" signatory.[5] Even if, however, New York law were applicable (and, as we shall show, it is not), the rule of the Wagner case would not dispose of the case before us.

For, in that case, the court laid stress on the landlord's knowledge that it was accepting the subsidiary's signature on the lease; there was, the court said, no concealment by the tenant. Here, however, a jury might well have found a fraudulent concealment by the responsible individuals of the fact that the ostensible tenant, although named "Mursam Shoe Corporation," was only a leasehold corporation which, contrary to representations deliberately made by the other defendants, was never intended to operate a shoe store. This alone would, in our opinion, create a triable issue. * * *

We are not, however, bound by New York law in our decision of this case. For the contract, a lease of New Jersey real estate, was made and recorded in New Jersey. While the trial court held that New Jersey followed the doctrine of the Wagner case, the only case cited for this assertion is hardly in point.[8] It would, indeed, be strange if New Jersey did follow New York law, since even before the harsh doctrine of the Wagner case was established, the leading treatise[9] in this field said that New York law "is probably more conservative than the general run of most jurisdictions," contrasting Berkey v. Third Avenue R. Co., 244 N.Y. 84, 155 N.E. 58, 50 A.L.R. 599[10] (which refused to impose liability on the parent of a street

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[3] Although the doctrine was there applied, as it had often been before, to a case involving the commodities clause of the Hepburn Act, 34 Stat. 584, 585, 49 U.S.C.A. § 1(8) and the Sherman Act, 15 U.S.C.A. §§ 1–7, 15 note, it has become a classic statement applied generally in cases piercing the corporate veil.

[4] That this is a question for the jury, see Summo v. Snare & Triest Co., 166 App.Div. 425, 428–430, 152 N.Y.S. 29.

[5] The policy of piercing the corporate veil on proper occasions is too strong to permit its circumvention by the defendants' reliance on the Statute of Frauds or the sealed instrument rule; the holding of the Wagner case, if taken as broadly as the defendant before us urges, would, in effect, destroy any possibility of holding the parent in contract cases.

[8] Beck v. Eagle Brewery of Newark, N.J.Ch.1895, 30 A. 1100. There the landlord sought to hold a corporation not named in the lease merely because it had some undisclosed agreement with the tenant and because it had paid the rent for several months. It did not occupy the premises, there was no evidence of any connection between it and the person who signed the lease, and the reason why it had paid any of the rent did not appear.

[9] Powell, Parent and Subsidiary Corporations (1931) 72.

[10] Although even that case was regarded as unusually conservative (Powell, su-

railway operated as part of a unified system) with Lehigh Valley R. Co. v. Dupont, 2 Cir., 128 F. 840, and Lehigh Valley R. Co. v. Delachesa, 2 Cir., 145 F. 617, in which, on similar facts, this court (in the old untrammeled days before Erie R. Co. v. Tompkins, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188, 114 A.L.R. 1487) imposed liability. New Jersey law is as yet relatively undeveloped, but some clue to the rationale which would be followed by its courts is afforded by Ross v. Pennsylvania Railroad, 1930, 106 N.J.L. 536, 148 A. 741, 743, where an administrator sued a parent corporation for damages caused by the act of its subsidiary. In holding the parent, the Court of Errors and Appeals said that liability must be imposed "where a corporation holds stock of another, not for the purpose of participating in the affairs of the other corporation, in the normal and usual manner, but for the purpose of control, so that the subsidiary company may be used as a mere agency or instrumentality for the stockholding company." This language echoes that of the United States Supreme Court, quoted above, in the Reading case, and suggests that New Jersey is not as reluctant as New York to hold corporate parents for the acts of their children. The holding of the Ross case is in conflict with the majority opinion in Berkey v. Third Avenue R. Co., supra, but is consistent with the dissent in that case and with the decisions of this court cited above. New Jersey law, therefore, is not identical with New York's.

Outside of New York, the doctrine hardly seems challenged that a representation that the liability of the subsidiary is the same as that of its parent or affiliate will result in a piercing of the corporate veil of a subsidiary which is in fact under-capitalized, dominated and used as an instrument of the parent.[11] Stark Electric R. Co. v. Mc-

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pra; 36 Yale L.J. (1927) 878; cf. 27 Col. 702 (1927) 705–706) and stimulated a strong dissent, it certainly did not go nearly so far as the Wagner case in relieving the parent of liability. See especially 244 N.Y. 84, at pages 93–95, 155 N.E. 58, 50 A.L.R. 599.

[11] Although some commentators have distinguished between the "agency" and "instrumentality" (or "identity") rationales for imposing liability upon the parent, few (if any) courts consistently follow one or the other. See Douglas and Shanks, supra, note 1. Normally, the theories are interchangeable, although the "identity" notion is often used to overcome such ancillary problems as the sealed instrument rule, the Statute of Frauds, election of remedies, service of process, and various pleading and practice difficulties. New York seems to have planted its own seeds of confusion in this jurisprudential jungle by adding the ground of "estoppel." See Wagner v. Manufacturers' Trust Co., supra. Who is estopped by what and against whom, is left in convenient obscurity. Apparently neither a general representation of unified operation (Berkey v. Third Ave. R. Co., supra), nor a specific statement that the parent is liable for its subsidiary's acts (Wagner v. Manufacturers' Trust Co., supra) is enough to work an "estoppel," the New York courts having in this respect repudiated the broad holding of the Quaid case that "the defendant * * * is estopped from denying the truth of his representation to the plaintiffs of the substantial identity of the corporation and himself, and that its obligations were his obligations." If such commingling and utter domination as was shown in Quaid v. Ratkowsky, 183 App.Div. 428, 170 N.Y.S. 812, 815, constitutes an estoppel, then the notion is only a form of the agency and/or identity rationales. Yet it is clear that disregard for corporate formalities need not go so far as in the Quaid case. See Mangan v. Terminal Transportation System, supra. (Query: What was the "estoppel" there?). Douglas and Shanks, supra, note 1, acutely point out that court decisions depend on the specific facts of each case rather than on an application of the various theories of legal liability. And in 1911, Machen, supra, note 1, concluded that "no other guide is desirable than sturdy common sense."

Ginty Contracting Co., 6 Cir., 238 F. 657; Platt v. Bradner Co., 131 Wash. 573, 230 P. 633; cf. Westinghouse Electric & Mfg. Co. v. Allis-Chalmers Co., 3 Cir., 176 F. 362, 367. Powell (loc.cit., p. 111) says that such a representation is "almost always fatal." The Wagner case stands alone in disregarding such a representation. We cannot assume that New Jersey would follow it. A more reasonable assumption is that a New Jersey court would impose liability on the parent, as have most other courts, if the jury found as a fact that the parent ran the subsidiary as a division of its own business and represented that the subsidiary's debts were its own obligations. This would be consistent with the rationale accepted in the Ross case. That same rationale would also indicate that New Jersey would not be troubled by the sealed instrument rule or the Statute of Frauds, since neither—as pointed out above—bars the imposition of liability upon the puppeteer who directed his marionette to sign.

We do not, of course, decide here that Mursam was, in fact, a dummy; we hold only that triable issues were created by plaintiff's allegations and affidavits that Mursam was a tool of the other defendants, and that the lease was made because of representations, believed by plaintiffs, that its liabilities were the obligations of the other defendants.

The order granting summary judgment and dismissing the complaint is reversed, and the case is remanded.

STONE et al. v. EACHO.[1]

In re TIP TOP TAILORS, Inc.

Circuit Court of Appeals of the United States, Fourth Circuit, 1942. 127 F.2d 284.

Proceedings in the matter of Tip Top Tailors, Inc., a Virginia corporation, bankrupt, wherein Stuart A. Eacho was appointed trustee in bankruptcy, and wherein Gerald D. Stone, trustee in bankruptcy of Tip Top Tailors, Inc., a Delaware corporation, bankrupt, filed a claim and a petition asking as alternative relief that bankruptcy proceedings relating to the two corporations be consolidated. Meinhard-Greeff & Co., Inc., and others, creditors of Tip Top Tailors, Inc., a Delaware corporation, bankrupt, filed intervening petitions praying the same relief. From an order subordinating the claim of Gerald D. Stone, trustee in bankruptcy, and refusing the petition to consolidate the bankruptcy proceedings, Gerald D. Stone, trustee in bankruptcy, and the intervening creditors appeal.

Reversed and remanded.

PARKER, CIRCUIT JUDGE. This is an appeal in the bankruptcy proceedings of the Tip Top Tailors, a Virginia corporation, from an order subordinating a claim of the trustee in bankruptcy of the Tip Top Tailors, a Delaware corporation, to the claims of other creditors of the Virginia corporation and refusing a motion to consolidate the

[1] Rehearing den. 128 F.2d 16 (C.C.A.4, 1942), cert. den. 317 U.S. 635, 63 S.Ct. 54 (1942).

bankruptcy proceedings of the Virginia corporation with those of the Delaware corporation pending in the District of New Jersey.

The Tip Top Tailors was incorporated under the laws of Delaware on January 23, 1939. Its principal place of business was in Newark, N. J., and it operated nine retail stores in various cities of the United States, one of these being located at Richmond, Va. On July 12, 1939 it secured a corporate charter from the State of Virginia for a corporation of the same name as that under which it was operating and caused three shares of stock, of the par value of $1 each, to be issued to its nominees to be held by them for its use and benefit. The officers of the two corporations were the same and no separate corporate activity of any sort on the part of the Virginia corporation is shown to have taken place. No money was paid into its treasury, no contracts were executed by it, no salaries were paid by it, unless the payment of wages to employees of the Richmond store from cash on hand be so regarded, and the only records kept for it were records kept in the office of the Delaware corporation at Newark, N. J., by an employee of that corporation. These records consisted of nothing more than transcriptions from the books of the Delaware corporation made by employees of that corporation at infrequent intervals.

Except for these book entries, and except for the fact that the Virginia charter was obtained, the Delaware corporation dealt with its Richmond, Va., store precisely in the same way as it dealt with the other stores that it was operating, as to which there was no pretense of separate incorporation. The manner of dealing with the Richmond store is thus described in the report of the special master approved by the court below, viz.:

"Sample bolts of goods and styles of suits were furnished the Richmond store by the parent corporation. A customer in Richmond, after selecting the style of suit and kind of cloth, was measured and the order was then sent from Richmond to Newark. In Newark the parent corporation then had the suit made up according to order, and shipped it back to the Richmond store, which made delivery to the customer and collected the price. At the end of each day the Richmond store would make out a complete and detailed report and send it by mail to Newark. Out of cash collected by the Richmond store salaries of the local store personnel were paid and petty items taken care of, and the balance of the money was deposited in a Richmond bank. This bank then forwarded these funds to the National City Bank of New York to the credit of the account of the Delaware corporation.

"In furnishing the Richmond store with cloth and their processing the suits for the local customers, the parent corporation made no profit. It furnished materials and labor at cost and debited the Richmond store with these amounts.

"Out of the cash collected in Richmond, the local store did not have authority to pay any bills over $10.00, with the exception of salaries. These petty cash items paid direct at Richmond in the course of a year's time would amount to not over $1,000.00. All other expenses incident to the operation and maintenance of the Richmond store were paid directly by the Delaware corporation by its own check,

and then debited on its books to the Richmond Store. In this way the parent corporation paid direct all expenses incident to the operation of the Richmond store, such as rent, insurance, stationery and supplies, telephone bills, delivery charges, express charges, taxes, light, heat, and power bills, unemployment insurance, payroll, etc.

"The parent corporation operated the Richmond store on the same basis as it did the other eight stores and charged the Richmond store with its proportionate share of the main office expense. The said expense being allotted to each of the stores in the proportion that the sales of the respective stores bore to the total sales. The only corporate record pertaining to the Virginia corporation consisted of a general ledger and a general journal. Entries in these books were only made once a year when certain items were taken off the records of the parent corporation and entered for the whole year on the ledger and journal of the Virginia corporation. All books and records of both corporations, during the entire term of the operation of the Richmond store, were kept under the supervision and control of one Henry Wegener, regular bookkeeper for the Delaware corporation, at its Newark offices acting under the instructions of the comptroller of the Delaware corporation."

To this should be added the fact that contracts with dealers in hats, shirts, etc., were made by the Delaware corporation authorizing such dealers to operate in the Richmond store, just as they operated in the other stores of the corporation, and that the Richmond store was charged and credited with respect to transactions arising out of these contracts, just as were the other stores.

With the exception of the three shares of the par value of $1 each, nothing was subscribed to the capital stock of the Virginia corporation; and, so far as the record shows, it owned no property of any sort. Fixtures, it is true, were placed in the Richmond store by the Delaware corporation and $900 was furnished it to take care of initial expenses; but these were charged to the Virginia corporation on the books of the Delaware corporation just as similar items were charged to its other stores and just as the goods furnished to the Richmond store were charged. By the time of the closing of the store, the excess of these charges over credits amounted to $39,069.67. Other debts of the Richmond store amounted to only about $12,000, included in which was a claim for rent, subject to reduction or adjustment.

On November 20, 1940, the Delaware corporation was adjudged bankrupt and appellant Stone was appointed its receiver. Two days later, two creditors attached the property in the Richmond store as property of the Virginia corporation; and on the following day an involuntary petition in bankruptcy was filed against the Virginia corporation by Stone as receiver of the Delaware corporation. The Virginia corporation was adjudged bankrupt on this petition and Stone, as receiver, thereupon filed claim for the sum of $39,069.67 as the amount owing by the Virginia corporation to the Delaware corporation. The trustee in bankruptcy of the Virginia corporation resisted the allowance of this claim and asked that, at all events, it be postponed to the claims of other creditors on the ground that the Virginia

corporation was not a separate entity, but a mere instrumentality or department of the Delaware corporation, and that the amount claimed was not a true indebtedness arising out of loans and advancements but represented a mere advancement of operating capital.

The issues thus arising on the objection to the claim were referred to a special master, who filed a report finding that the Virginia corporation was a "mere shell without reality" and a "mere agency or corporate pocket" of the Delaware corporation, and recommending that the claim be postponed to the claims of other general creditors of the Virginia corporation. Appellant duly excepted to this report and filed a petition asking, as alternative relief, that the corporate entity of the Virginia corporation be entirely disregarded and that the bankruptcy proceedings relating to that corporation be consolidated with the bankruptcy proceedings of the Delaware corporation, to the end that all creditors of the last-named corporation, including those who had proved claims in the Virginia proceedings, share pari passu in the distribution of the consolidated assets. Three creditors of the Delaware corporation filed intervening petitions praying this relief. The District Judge entered order denying this motion and affirming the report of the special master; and from this order the trustee of the Delaware corporation and the three intervening creditors have appealed.

There is nothing in the record before us to show that any of the creditors who filed claims in the bankruptcy proceedings of the Virginia corporation intended to extend credit particularly to that corporation; and the fact that the bills of the Richmond store were paid by the Delaware corporation from its Newark office would indicate that it must have been generally known to the creditors of the Richmond store that it was the Delaware corporation that was there engaged in business. There is no reason apparent from the record why all creditors of that corporation should not be treated in exactly the same way; and the fact that it had obtained a charter from the State of Virginia furnishes no good reason why the creditors dealing with its Richmond store should be dealt with differently from its other creditors, since there is no showing that business was done under that charter or that any of the creditors knew anything about it or relied on it in any way. If the Virginia corporation is treated as a separate entity and the property used in the Richmond business is applied to its debts, and the claim of the Delaware corporation is postponed in accordance with the ruling below, those creditors who have dealt with the Richmond store and have proven claims in the Virginia proceeding will have their claims practically paid in full, whereas other creditors of the Delaware corporation will receive less than 30% on their claims in the bankruptcy proceeding pending in New Jersey. If, on the other hand, the Virginia corporation is treated as a separate entity and the claim of the Delaware corporation is not postponed, this claim will so far absorb the assets at Richmond that other creditors proving in the Virginia proceeding will receive less than half the dividend received by creditors in the New Jersey proceeding. Only by entirely ignoring the separate corporate entity of the Virginia corporation and consolidating the proceedings here

with those of the parent corporation in New Jersey can all the creditors receive that equality of treatment which it is the purpose of the bankruptcy act to afford; and this, we think, is the course that should be followed.

We agree with the court below that, if the separate existence of the Virginia corporation is recognized, the claim of the Delaware corporation should be postponed to the claims of other creditors. It is too well settled to admit of argument that the claims of a parent corporation against a subsidiary should be thus postponed where the subsidiary, as here, has in reality no separate existence, is not adequately capitalized and constitutes a mere instrumentality of the parent corporation or a mere "corporate pocket" or department of its business. [Citing cases.] And even in the case of the insolvency of both corporations there may be reason for recognizing the separate entity of the subsidiary and postponing the claim of the parent, where the subsidiary has been allowed to transact business as an independent corporation and credit has been extended to it as such on the faith of its ownership of the assets in its possession. Latty, Subsidiaries and Affiliated Corporations, supra, pp. 153–155. But in a case such as this, where both corporations are insolvent, where the business has been transacted by and the credit extended to the parent corporation, and where the subsidiary has no real existence whatever, there is no reason why the courts should not face the realities of the situation and ignore the subsidiary for all purposes, allowing the creditors of both corporations to share equally in the pooled assets. As said in Latty, supra: "Perhaps the fairest way of dealing with the situation when both the parent and the subsidiary corporations are insolvent is to let all the creditors of each share pro rata in the pooled assets of both. Such procedure would be especially equitable where the claimants are creditors of both the parent and the subsidiary."

It is well settled that courts will not be blinded by corporate forms nor permit them to be used to defeat public convenience, justify wrong or perpetrate fraud, but will look through the forms and behind the corporate entities involved to deal with the situation as justice may require. [Citing cases.] Not only is this done for the purpose of holding a stockholder or parent corporation for debts created by an insolvent corporate agent or subsidiary which is a mere instrumentality of the stockholder or parent, but also for the purpose of allowing the creditors of the stockholder or parent to reach assets held by such a subsidiary. [Citing cases.] And, where the court decides that the corporate entity of the subsidiary should be completely ignored and its assets and liabilities treated as those of the parent corporation, it is both logical and convenient that this be done in one proceeding. [Citing cases.]

* * * Through long practice courts have not hesitated to disregard the doctrine of corporate entities when the facts justify it. Although we know of no instance in which it has been done in matters of receivership, we cannot see why the same power does not exist in a court or why the law does not impose upon a court the same duty in a receivership matter when, as here, the facts are substantial enough to justify, indeed to compel, a finding that the five cor-

porations were so identified with the parent corporation as to be a part of it. Being of opinion that the law makes no exception of receiverships, we tear asunder the legal maze of corporate fiction in which they have enveloped themselves and, observing that the six corporations were not merely related by stock ownership but, like wheels in a machine, were so closely meshed that all functioned together, we find from the bills that in legal effect they were one, a finding in consonance with the casual statement of the attorney for the parent corporation at the hearing that 'the whole thing from Alabama to Pennsylvania is really one company.' " * * *

If there are equities in favor of any of the creditors which have not been sufficiently explored in the motion for consolidation and as to which they desire to be heard further, hearing can be afforded them in the consolidated proceedings. In re Foley, 9 Cir., 4 F.2d 154, certiorari denied 269 U.S. 554, 46 S.Ct. 18, 70 L.Ed. 408. Since, however, the assets in Virginia are unquestionably the assets of the parent corporation, and since all of the creditors of that corporation, and not merely those who have dealt with the Virginia store, have rights with respect thereto, as well as with respect to other assets of the corporation, these rights should be determined in the bankruptcy proceeding of the parent corporation, and the two proceedings should be consolidated that this may be done, with a pooling of assets and with the treatment of claims filed in either proceeding as having been filed in the proceeding as consolidated. Proper provision should of course be made for the payment of the costs that have been incurred in the course of the Virginia proceeding.

For the reasons stated, the order appealed from will be reversed and the cause will be remanded for further proceedings in accordance herewith.

Reversed and remanded.

CONSOLIDATED ROCK PRODUCTS COMPANY et al. v. DU BOIS.

Supreme Court of the United States, 1941. 312 U.S. 510, 61 S.Ct. 675.

Proceeding in the matter of the reorganization of the Consolidated Rock Products Company, debtor, and the Union Rock Company and the Consumers Rock & Gravel Company, Incorporated, subsidiaries, wherein E. Blois du Bois, bondholder, objected to confirmation of reorganization plan. To review a decision of the Circuit Court of Appeals, 114 F.2d 102, reversing a judgment confirming the plan, the Consolidated Rock Products Company and others and F. D. Badgley and others bring certiorari.

Affirmed.

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

This case involves questions as to the fairness under § 77B of the Bankruptcy Act, 48 Stat. 912, 11 U.S.C.A. § 207, of a plan of reorganization for a parent corporation (Consolidated Rock Products Co.)

and its two wholly owned subsidiaries [1] Union Rock Co. and Consumers Rock and Gravel Co., Inc. The District Court confirmed the plan; the Circuit Court of Appeals reversed. In re Consolidated Rock Products Co., 9 Cir., 114 F.2d 102. We granted the petitions [2] for certiorari because of the importance in the administration of the reorganization provisions of the Act of certain principles enunciated by the Circuit Court of Appeals.

The stock of Union and Consumers is held by Consolidated. Union has outstanding in the hands of the public [3] $1,877,000 of 6% bonds secured by an indenture on its property, with accrued and unpaid interest [4] thereon of $403,555—a total mortgage indebtedness of $2,280,555. Consumers has outstanding in the hands of the public [5] $1,137,000 of 6% bonds secured by an indenture on its property, with accrued and unpaid interest [6] thereon of $221,715—a total mortgage indebtedness of $1,358,715. Consolidated has outstanding 285,947 shares of no par value preferred stock [7] and 397,455 shares of no par common stock.

The plan of reorganization calls for the formation of a new corporation to which will be transferred all of the assets of Consolidated, Union,[8] and Consumers free of all claims.[9] The securities of the new corporation are to be distributed as follows:

Union and Consumers bonds held by the public will be exchanged for income bonds [10] and preferred stock [11] of the new company. For 50 per cent of the principal amounts of their claims, those bondholders will receive income bonds secured by a mortgage on all of the

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1 The proceedings under § 77B were instituted in 1935 by the filing of separate voluntary petitions by Consolidated, Union and Consumers. No trustees have been appointed, Consolidated remaining in possession.

2 The petition in No. 400 raises all of the questions discussed herein, while the petition in No. 444 raises only the question as to the authority of the reorganization court to approve a plan which substitutes one mortgage covering all of the property for so-called divisional mortgages on separate units of that property. The Interstate Commerce Commission and the Securities and Exchange Commission filed memoranda urging that the petition in No. 444 be granted and that the petition in No. 400 be granted to the extent that it raised the same question as that presented by the petition in No. 444. 311 U.S. 636, 61 S.Ct. 71, 85 L.Ed. 405; 311 U.S. 636, 61 S.Ct. 76, 85 L.Ed. 405.

3 $102,500 face amount of Union's bonds are held by Consolidated.

4 As of April 1, 1937, the effective date of the plan. Interest on Union bonds has been in default since March 1, 1934.

5 $63,500 face amount of Consumer's bonds are held by Consolidated.

6 Interest has been in default since July 1, 1934.

7 With a preference on liquidation of $25 per share plus accrued dividends.

8 Reliance Rock Co. is a wholly owned subsidiary of Union whose properties also were to be transferred to the new company.

9 The claims of general creditors will be paid in full or assumed by the new company.

10 These bonds will mature in 20 years and will bear interest at the rate of 5 per cent if earned. The interest will be cumulative if not paid. The bonds, as well as the preferred stock, to be issued to Union and Consumers bondholders will be in separate series. The net income of the new company is to be divided into two equal parts: each part to be used to pay, with respect to bonds and preferred stock of each series, first, interest and sinking fund payments on the bonds; second, dividends and sinking fund payments on the preferred stock. Income remaining will be available for general corporate purposes.

11 The new preferred stock will have a par value of $50 and will carry a dividend of 5 per cent. It will be noncumulative until the retirement of the bonds of the same series except to the extent that net income is available for dividends. Thereafter it will be cumulative.

property of the new company; for the balance they will receive an equal amount of par value preferred stock. Their claims to accrued interest are to be extinguished, no new securities being issued therefor. Thus Union bondholders for their claims of $2,280,555 will receive income bonds and preferred stock in the face amount of $1,877,000; Consumers bondholders for their claims of $1,358,715 will receive income bonds and preferred stock [12] in the face amount of $1,137,000. Each share of new preferred stock will have a warrant for the purchase of two shares of new $2 par value common stock at prices ranging from $2 per share within six months of issuance, to $6 per share during the fifth year after issuance.

Preferred stockholders of Consolidated will receive one share of new common stock ($2 par value) for each share of old preferred or an aggregate of 285,947 shares of new common.

A warrant to purchase one share of new common for $1 within three months of issuance will be given to the common stockholders of Consolidated for each five shares of old common.[13]

The new preferred stock, to be received by the old bondholders, will elect four out of nine directors of the new company; the new common stock will elect the remainder.[14] But on designated delinquencies in payment of interest on the new bonds, the old bondholders would be entitled to elect six of the nine directors.

The bonds of Union and Consumers held by Consolidated,[15] the stock of those companies held by Consolidated, and the intercompany claims (discussed hereafter) will be cancelled.

In 1929 when Consolidated acquired control of these various properties, they were appraised in excess of $16,000,000 and it was estimated that their annual net earnings would be $500,000. In 1931 they were appraised by officers at about $4,400,000, "exclusive of going concern, good will and current assets." The District Court did not find specific values for the separate properties of Consolidated, Union, or Consumers, or for the properties of the enterprise as a unit. The average of the valuations (apparently based on physical factors) given by three witnesses [16] at the hearing before the master were $2,202,733 for Union as against a mortgage indebtedness of $2,280,555; $1,151,033 for Consumers as against a mortgage indebtedness of $1,358,715. Relying on similar testimony, Consolidated argues that the value of its property, to be contributed to the new company, is over $1,359,000, or exclusive of an alleged good will of $500,000, $859,784. These estimated values somewhat conflict with the consolidated balance sheet (as at June 30, 1938) which shows assets of $3,723,738.15 and liabilities (exclusive of capital and sur-

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12 All of the new income bonds and preferred stock are to be issued to the public holders of Union and Consumers bonds.

13 79,491 shares of new common will be reserved for the exercise of warrants issued to old common stockholders; an additional 60,280 shares of new common, for the exercise of warrants attached to the new preferred.

14 It is apparent that the majority of the new common will be held by the old preferred stockholders even if all warrants are exercised.

15 See notes 3 and 5, supra.

16 Two officers and one ex-employee. These valuation figures included the properties of Reliance. See note 8, supra.

plus) of $4,253,224.41. More important, the earnings record of the enterprise casts grave doubts on the soundness of the estimated values. No dividends were ever paid on Consolidated's common stock; and except for five quarterly dividends in 1929 and 1931, none on its preferred stock. For the eight and a half years from April 1, 1929, to September 30, 1937, Consolidated had a loss of about $1,200,000 before bond interest but after depreciation and depletion. And except for the year 1929, Consolidated had no net operating profit, after bond interest and amortization, depreciation and depletion, in any year down to September 30, 1937.[17] Yet on this record the District Court found that the present fair value of all the assets of the several companies, exclusive of good will and going concern value, was in excess of the total bonded indebtedness, plus accrued and unpaid interest. And it also found that such value, including good will and going concern value, was insufficient to pay the bonded indebtedness plus accrued and unpaid interest and the liquidation preferences and accrued dividends on Consolidated preferred stock. It further found that the present fair value of the assets admittedly subject to the trust indentures of Union and Consumers was insufficient to pay the face amount, plus accrued and unpaid interest of the respective bond issues. In spite of that finding, the District Court also found that "it would be physically impossible to determine and segregate with any degree of accuracy or fairness properties which originally belonged to the companies separately"; that as a result of unified operation properties of every character "have been commingled and are now in the main held by Consolidated without any way of ascertaining what part, if any thereof, belongs to each or any of the companies separately"; and that, as a consequence, an appraisal "would be of such an indefinite and unsatisfactory nature as to produce further confusion."

The unified operation which resulted in that commingling of assets was pursuant to an operating agreement which Consolidated caused its wholly owned subsidiaries to execute in 1929. Under that agreement the subsidiaries ceased all operating functions and the entire management, operation and financing of the business and properties of the subsidiaries were undertaken by Consolidated. The corporate existence of the subsidiaries, however, was maintained and certain separate accounts were kept. Under this agreement Consolidated undertook, inter alia, to pay the subsidiaries the amounts necessary for the interest and sinking fund provisions of the indentures and to credit their current accounts with items of depreciation, depletion, amortization and obsolescence. Upon termination of the agreement the properties were to be returned and a final settlement of accounts made, Consolidated meanwhile to retain all net revenues after its obligations thereunder to the subsidiaries had been met. It was specifically provided that the agreement was made for the benefit of the parties, not "for the benefit of any third person." Consolidated's books as at June 30, 1938, showed a net indebtedness under that agreement to Union and Consumers of somewhat over $5,000,000. That claim was cancelled by the plan of reorganization, no securities be-

[17] The hearings on the plan were held before a master during November, 1937.

ing issued to the creditors of the subsidiaries therefor. The District Court made no findings as respects the amount or validity of that intercompany claim; it summarily disposed of it by concluding that any liability under the operating agreement was "not made for the benefit of any third parties and the bondholders are included in that category."

We agree with the Circuit Court of Appeals that it was error to confirm this plan of reorganization.

I. On this record no determination of the fairness of any plan of reorganization could be made. Absent the requisite valuation data, the court was in no position to exercise the "informed, independent judgment" (National Surety Co. v. Coriell, 289 U.S. 426, 436, 53 S.Ct. 678, 681, 682, 77 L.Ed. 1300, 88 A.L.R. 1231) which appraisal of the fairness of a plan of reorganization entails. Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110. And see First National Bank v. Flershem, 290 U.S. 504, 525, 54 S.Ct. 298, 306, 78 L.Ed. 465, 90 A.L.R. 391. * * *

There are no barriers to a valuation and enforcement of that claim. If as Consolidated maintains the subsidiaries have no present claim against it,[22] the claim can readily be discounted to present worth. It is provable by trustees of the subsidiaries, for the term "creditors" under § 77B, sub. b, includes "holders of claims of whatever character against the debtor or its property, including claims under executory contracts, whether or not such claims would otherwise constitute provable claims under this Act [title]."[23] Consolidated makes some point of the difficulty and expense of determining the extent of its liability under the operating agreement and of the necessity to abide by the technical terms of that agreement[24] in ascertaining that liability. But equity will not permit a holding company, which has dominated and controlled its subsidiaries, to escape or reduce its liability to those subsidiaries by reliance upon self-serving contracts which it has imposed on them. A holding company, as well as others in dominating or controlling positions (Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281), has fiduciary duties to security holders of its system which will be strictly enforced. See Taylor v. Standard Gas & Electric Co., 306 U.S. 307, 59 S.Ct. 543, 83 L.Ed. 669. In this connection Consolidated cannot defeat or postpone the accounting because of the clause in the operating agreement that it was not made for the benefit of any third person. The question here is not a technical one as to who may sue to enforce that liability. It is merely a question as to the amount by which Consolidated is in-

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[22] Consolidated maintains that there is no present claim against it because no claim exists until termination of the operating agreement which ran until February, 1938, with an option in Consolidated to extend it for five years. But it does not assert, nor does the record show, that the option was exercised. But even if it had been, only the time when the amounts accrued were payable would be affected.

[23] For an equally broad definition of "creditor" under Ch. X of the Chandler Act, 52 Stat. 840, see § 106, subs. 1 and 4, 11 U.S.C.A. § 506, subs. 1, 4.

[24] Thus Consolidated argues that under the operating agreement the machinery for an appraisal provided therein must be employed. Yet assuming arguendo that that is true, Consolidated which has been in possession and control throughout cannot rely on the failure to have an appraisal as a reason for blocking or delaying its duty to account.

debted to the subsidiaries and the proof and allowance of that claim. The subsidiaries need not be sent into state courts to have that liability determined. The bankruptcy court having exclusive jurisdiction over the holding company and the subsidiaries has plenary power to adjudicate all the issues pertaining to the claim. The intimations of Consolidated that there must be foreclosure proceedings and protracted litigation in state courts involve a misconception of the duties and powers of the bankruptcy court. The fact that Consolidated might have a strategic or nuisance value outside of § 77B does not detract from or impair the power and duty of the bankruptcy court to require a full accounting as a condition precedent to approval of any plan of reorganization. The fact that the claim might be settled, with the approval of the Court after full disclosure and notice to interested parties, does not justify the concealed compromise effected here through the simple expedient of extinguishing the claim.

So far as the ability of the bondholders of Union and Consumers to reach the assets of Consolidated on claims of the kind covered by the operation agreement is concerned, there is another and more direct route which reaches the same end. There has been a unified operation of those several properties by Consolidated pursuant to the operating agreement. That operation not only resulted in extensive commingling of assets. All management functions of the several companies were assumed by Consolidated. The subsidiaries abdicated. Consolidated operated them as mere departments of its own business. Not even the formalities of separate corporate organizations were observed, except in minor particulars such as the maintenance of certain separate accounts. In view of these facts, Consolidated is in no position to claim that its assets are insulated from such claims of creditors of the subsidiaries. To the contrary, it is well settled that where a holding company directly intervenes in the management of its subsidiaries so as to treat them as mere departments of its own enterprise, it is responsible for the obligations of those subsidiaries incurred or arising during its management. * * * We are not dealing here with a situation where other creditors of a parent company are competing with creditors of its subsidiaries. If meticulous regard to corporate forms, which Consolidated has long ignored, is now observed, the stockholders of Consolidated may be the direct beneficiaries. Equity will not countenance such a result. A holding company which assumes to treat the properties of its subsidaries as its own cannot take the benefits of direct management without the burdens.

We have already noted that no adequate finding was made as to the value of the assets of Consolidated. In view of what we have said, it is apparent that a determination of that value must be made so that criteria will be available to determine an appropriate allocation of new securities between bondholders and stockholders in case there is an equity remaining after the bondholders have been made whole. * * *

Affirmed.

TAYLOR et al. v. STANDARD GAS & ELECTRIC COMPANY et al.

Supreme Court of the United States, 1939. 306 U.S. 307, 59 S.Ct. 543.

Proceedings for reorganization under section 77B of the Bankruptcy Act, 11 U.S.C.A. § 207, by the Deep Rock Oil Corporation, debtor, wherein H. N. Greis was appointed trustee, the Standard Gas & Electric Company filed proof of claim, the Reorganization Committee of the Deep Rock Oil Corporation intervened, and wherein John M. Taylor and others, as the Independent Committee for the Protection of the Holders of the Preferred Stock of the Deep Rock Oil Corporation, also intervened. Orders confirming a plan of reorganization and approving a compromise of a claim of the Standard Gas & Electric Company against the debtor as an integral part of the plan were affirmed by the Circuit Court of Appeals, 96 F.2d 693, and John M. Taylor and others, as the Independent Committee, bring certiorari.

Reversed.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The question presented is whether the District Court abused its discretion in approving the compromise of a claim by a parent against a subsidiary corporation and plan of reorganization based upon the compromise, in proceedings under Section 77B of the Bankruptcy Act.[1] The Circuit Court of Appeals, by a divided court, approved the District Court's order.[2]

The petitioners are a committee for the protection of preferred stockholders. The respondents are the trustee of the debtor, Deep Rock Oil Corporation (a Delaware corporation whose business was that of producing, refining, and selling gasoline, oil, and other petroleum products, from lands located in Oklahoma, Kansas, Texas, and Arkansas), a reorganization committee, representing note-holders and certain holders of preferred stock, and Standard Gas and Electric Company, which owns practically all of the common stock of the debtor, claiming as a creditor.

The debtor was organized in 1919 to take over the properties then being operated by one C. B. Shaffer.[3] Standard Gas & Electric Company, hereinafter called Standard, then had investments in various utility properties but had never been interested in oil. Byllesby & Company, hereinafter called Byllesby, an investment banking corporation which controlled Standard, entered into a contract with Shaffer whereby he was to organize the debtor corporation and to be paid by that corporation for his properties $15,580,000 made up of cash, a note, and preferred and common stock of the company. Byllesby agreed to purchase $11,000,000 par value of first mortgage bonds of an authorized issue of $15,000,000, $5,000,000 par value of preferred

1 U.S.C.A. Tit. 11, Sec. 207.

2 Taylor et al. v. Standard Gas & Electric Co. et al., 10 Cir., 96 F.2d 693.

3 The corporate name was Shaffer Oil & Refining Company. This was changed in 1931 to Deep Rock Oil Corporation. The company will be referred to by the latter name.

stock, and 120,000 shares of common stock, par $1, for $15,200,000 in cash, to be applied by the company to the cash payments to be made to Shaffer and for working capital.

Shaffer received for the properties turned over by him 80,000 shares of common stock, 50,000 shares of $100 par preferred stock, $9,500,-000 in cash and a note of Byllesby and Standard for $1,000,000. In fact $12,000,000 of the first mortgage bonds were underwritten by a syndicate formed by Byllesby and sold to the public. The result of the above transactions was to leave Deep Rock with approximately $6,700,000 of cash. Shortly thereafter the remaining $3,000,000 of bonds were pledged to secure Deep Rock's notes for $2,000,000. From its organization Deep Rock was, most of the time, "two jumps ahead of the wolf", as one of Standard's officers testified. The common stock went into a voting trust which gave Standard and Shaffer equal control. Shaffer undertook the management of the properties and business. After two years Standard became dissatisfied with Shaffer's management and he severed his connection with the company selling his common stock to Standard and surrendering to Deep Rock 50,000 shares of preferred stock which was canceled.

Thenceforward the debtor was under the complete control and domination of Standard through ownership of the common stock. Standard's officers, directors, and agents always constituted a majority of the Board. The remaining directors were operating officers or employes of Deep Rock who had been employed on behalf of Deep Rock by Standard or by Byllesby Management Corporation, hereafter called Management Corporation, a wholly owned subsidiary of Standard, or were under the complete control of Standard. A majority of Deep Rock's officers were officers or directors of Standard or of the Management Corporation, or of both. The officers of the debtor, who were chosen for their technical or business experience in the oil industry, although allowed some discretion in the matter of development and operation of the oil properties, reported to and were always subject to the direction of officers and directors of Standard. All of the fiscal affairs of the debtor were wholly controlled by Standard, which was its banker and its only source of financial aid.

Deep Rock was placed in the hands of a receiver in March 1933 and the present proceeding under Section 77B of the Bankruptcy Act was instituted in June 1934. Standard filed a claim as a creditor in the receivership and in the bankruptcy proceedings, which the receivers and the trustee resisted. The claim was referred to a master, before whom trial lasted many months. All the witnesses were officers, directors or agents of Standard, or its affiliates, and officers of the debtor. All the documentary evidence came from the books and records of Standard and Deep Rock. The basis of claim was an open account which embraced transactions between Standard and Deep Rock from the latter's organization in 1919 to the receivership in 1933. The account consists of thousands of items of debit and credit. The book entries were made under the direction of Standard's auditing department, which supervised the auditing department of Deep Rock, and it is not surprising, therefore, that the books of the two companies agree with respect to all items.

The account contains debits to Deep Rock in excess of $52,000,000 and credits of approximately $43,000,000 leaving a balance shown to be due Standard of $9,342,642.37, which was the amount of the claim presented. Cash payments by Standard to Deep Rock, or to others for its account, as shown by the books, total $31,804,145.04. Management and supervision fees paid or credited to Management Corporation amount to $1,219,034.83. Interest charges by Standard to Deep Rock on open account balances total $4,819,222.07. Rental charges upon a lease to Deep Rock of oil properties owned by a Standard subsidiary but claimed by petitioners to belong, in equity, to Deep Rock, amount to $4,525,000. Debits by Standard to Deep Rock of the amounts of dividends declared by Deep Rock to Standard, but not paid, reach the sum of $3,502,653. In addition there are hundreds of debits and credits representing other inter-company items.

Two preferred stockholders were permitted to intervene in the proceedings and they joined in the trustee's objections to the claim. Many transactions entered in the account were attacked as fraudulent and it was asserted that as Standard had made Deep Rock its mere agent or instrumentality it could not transmute itself from the status of the proprietor of Deep Rock's business to that of creditor. The hearings before the master were closed, but before he made any report, and as a result of negotiations intiated by the reorganization committee organized at the instance of Byllesby, representing approximately eighty-two per cent. of the noteholders and sixty per cent. of the preferred stockholders of Deep Rock, Standard proposed a compromise of its claim.

The court referred the proposal to the master who reported favorably. The trustee and his counsel also recommended the approval of the compromise, which involved the allowance of Standard's claim at $5,000,000. In contemplation of the approval of this compromise a reorganization of Deep Rock was proposed by the reorganization committee. The plan was based upon the trustee's appraisal of the debtor's assets at $16,800,000, of which $7,300,000 represented net current assets, mainly cash, and the remainder comprised fixed assets valued at $9,500,000. It provided that upon approval of the compromise of Standard's claim, the reorganization would be effected by the formation of a new company which would take over the debtor's assets and would issue $10,000,000 par value of fifteen year six per cent. income debentures which were to go to the holders of the debtor's unpaid notes of like amount; 25,000 shares of $7 cumulative preferred stock and 520,000 shares of no par common stock, of which the entire preferred stock and 390,000 shares of common should go to Standard on account of its claim, 80,000 shares of common to the noteholders, and 50,000 shares of common to the preferred stockholders of the old company. Standard's claim to the extent of $3,500,000 was to stand on a parity with the debtor's notes.

In the District Court the petitioners insisted that as the testimony before the master had been closed he should be required to pass upon the provability of Standard's claim and no reorganization plan should be considered until the validity of the claim had been adjudicated. The court, without passing on this demand, refused to approve the

compromise or the plan of reorganization. Referring to the 50,000 shares of preferred stock outstanding, the judge stated that somebody had received the money represented by this stock from the public; that the plan in effect wiped out preferred stockholders and that he could not approve any plan which had this effect. In the course of the hearing he stated: "The evidence is overwhelming that Standard ran this company; they officered it; they capitalized it; it is just a child in their hands, and if there ever was a case the law is clear on, it is nothing but an instrumentality, according to the admissions." He indicated, however, that he would approve a plan according Standard a parity with the noteholders for a smaller proportion of its claim allowing the balance on a parity with the preferred stockholders, and suggested that the parties negotiate further in an effort to reach a fair result.

Months later the reorganization committee presented an amended plan which, as modified by the Court, contemplated the compromise of Standard's claim at $5,000,000, as before, and the organization of a new company which should issue $10,000,000 par value of debentures and 520,000 shares of common stock. These securities were to be distributed as follows: The new issue of debentures was to go to the holders of the old notes. In lieu of interest on the old notes accumulated to January 1, 1937, totaling $2,300,000, the noteholders were to receive $1,200,000 in cash and 40,000 shares of common stock; interest accruing subsequent to January 1, 1937, was to be paid in cash. The old preferred stockholders were to receive 100,000 shares of common stock and Standard was to receive for its claim 380,000 shares of common stock. Thus there was allocated to Standard approximately seventy-three per cent., to the old preferred stockholders nineteen per cent., and to the noteholders eight per cent. of the common stock. The District Court permitted the petitioners to intervene and, over their objections, approved the compromise and the plan. A majority of the Circuit Court of Appeals examined the record only to the extent of determining that it was possible that Standard might establish its claim in whole or in part, and concluded that the District Court had not exceeded the bounds of reasonable discretion in granting its approval. One judge thought that the instrumentality rule was applicable; that, under the rule, Standard had no provable claim; and that it was an abuse of discretion to approve the compromise and the reorganization plan. We agree with the conclusion of the dissenting judge, but for different reasons.

The petitioners insist that the appraisal upon which the plan was based was inordinately low and that, for this reason alone, the plan should not have been approved. The appraisal was supported by substantial evidence and the values shown by it were approved and adopted by the District Court and by the Circuit Court of Appeals. We accept the concurrent findings of the two courts that the value of the debtor's assets does not exceed $17,000,000.

As the debentures to be issued to the noteholders, plus the cash they are to get, total $11,200,000, the equity remaining in the property is not over $5,800,000. Standard's share of this equity will be seventy-three per cent., or $4,234,000, and will give it complete con-

trol of the new company. The preferred stockholders will receive nineteen per cent. or $1,020,000,—a minority interest without representation on the board of directors. The question is whether, within the bounds of reason and fairness, such a plan can be justified. We think the history of Standard's dealings with Deep Rock requires a negative answer.

Without going into the minutiæ of the transactions between the two companies, enough may be stated to expose the reasons for our decision. As has been stated, Standard came into complete control of Deep Rock in 1921. From the outset Deep Rock was insufficiently capitalized, was topheavy with debt and was in parlous financial condition. Standard so managed its affairs as always to have a stranglehold upon it.

At organization Deep Rock had cash working capital of only about $6,600,000 and a mortgage indebtedness of $12,000,000, the interest and sinking fund requirements of which were nearly $2,000,000 a year. Its assets at that time were appraised at about $16,000,000. Shortly thereafter it created a further note issue of $2,000,000. Upon the acquirement of Shaffer's interest, in 1921, Standard caused Deep Rock to issue short term notes of a par of $3,500,000. Deep Rock also, between 1921 and 1924, borrowed substantial sums on promissory notes some of which were discounted or subsequently taken up by Standard. So inadequate was Deep Rock's capitalization that, in the period from organization to 1926, the balance due on open account to Standard grew to more than $14,800,000. Standard determined to place some of this indebtedness of Deep Rock with the public. In order to do so it had to improve Deep Rock's balance sheet. This it did by purchasing 80,000 shares of preferred stock for which it credited Deep Rock $7,223,333.33. It then bought $7,500,000 face value two year six per cent. notes for $7,273,750, which were sold to the public through a syndicate organized by Byllesby. Deep Rock's requirements of additional capital persisted and, by the spring of 1928, the open account and a note which Deep Rock had given Standard for advances totaled over $11,000,000. As the two year notes held by the public were maturing, Standard found it necessary to make a new offering. There still remained nearly $2,000,000 of first mortgage bonds outstanding which had to be retired to make an unsecured note issue salable. Standard, therefore, determined that Deep Rock's balance sheet must again be put in such shape that notes could be sold. It accordingly purchased common stock from Deep Rock to the amount of the then open balance and commuted 90,000 shares of the preferred stock, which it held, into common. It caused Deep Rock to issue $10,000,000 of six per cent. notes which were sold by a syndicate organized by Byllesby and applied the proceeds to the redemption of the two year notes and the outstanding mortgage bonds. This financing, however, merely changed the character of Deep Rock's funded indebtedness and gave it no new working capital. This $10,000,000 note issue is the one now outstanding. As before, Deep Rock's resources were wholly insufficient for its business and the open account began again to build up so that be-

tween February 1928 and February 1933, the date of receivership, the account had grown to $9,342,642.37.

No dividends were paid on preferred stock until 1926. In that and the following year existing arrearages were paid by Standard, for Deep Rock's account, in the amount of $1,435,813. Between 1928 and 1931 Standard advanced Deep Rock, for payment of preferred dividends, $1,106,706.

During the period between 1926 and 1929 Deep Rock declared dividends on its common stock in a total of $3,064,685.50. Of these dividends $1,946,672 was charged by Standard, as owner of common stock, against Deep Rock in the open account. Standard took new common stock for dividends to the amount of $1,015,437.50 and advanced Deep Rock cash to pay dividends to outside holders of common stock in the sum of $102,576. Against the total of $2,645,095 advanced by Standard to pay Deep Rock's dividends, Standard credited payments received from Deep Rock in the open account in the sum of $927,500.

These dividends were declared in the face of the fact that Deep Rock had not the cash available to pay them and was, at the time, borrowing in large amounts from or through Standard.

About 1922 Standard decided that, in view of the unsatisfactory progress of Deep Rock, earnings must be increased by the acquisition of additional oil properties and by the erection of a modern gasoline cracking plant. Upon recommendation of the operating officials, Standard decided that Deep Rock should purchase the so-called Bradstreet properties, the price of which was $650,000. Of this amount $500,000 was advanced by Standard for account of Deep Rock and $150,000 paid by notes of Deep Rock. Title to the property was taken in the name of J. C. Kennedy, an employe of Deep Rock, as trustee. Kennedy never executed any declaration of trust. Deep Rock charged against him not only the original purchase price of the Bradstreet properties but the moneys thereafter expended in their development and in the acquisition of additional leases, amounting, to October 1, 1925, to $1,033,294.32, much of which represented advances by Standard.

In 1922 Deep Rock conveyed a small portion of its land to R. J. Graf, a Standard official, as trustee. Upon this land Deep Rock erected a new cracking plant at a total cost of $861,297.79. This expenditure was charged to R. J. Graf, trustee. Again part or all of the sums so expended were advanced by Standard to Deep Rock and charged against the latter.

In 1922 Standard had caused a company to be formed in Delaware known as Deep Rock Oil and Refining Company, intending that it should take title to the Bradstreet properties and the cracking plant. The purpose, as Standard's officers now state, was to keep these assets from going into direct ownership of Deep Rock and thus coming under the lien of its mortgage, so that they could be used as the basis of additional financing. The records of the Refining Company show that its capital stock was issued against the transfer by Kennedy and Graf as trustees of the Bradstreet and cracking properties but there

are no corporate records of Deep Rock or of Standard concerning any actual transfer and no book entries of Deep Rock or Standard were made concerning the supposed transfer until December 1925, as of October 1, 1925. At that time, by direction of one Brahaney, the chief accounting officer of Standard, entries were made in Standard's books and those of Deep Rock to evidence the following transaction: Standard assumed the advances made by Deep Rock for improvement of the Bradstreet properties and the cracking plant totaling $1,894,592.11 by crediting Deep Rock with that sum and Refining Company gave its note to Standard in that amount. Deep Rock also credited Kennedy, Trustee, with the $650,000 paid for the Bradstreet properties and Standard assumed this charge. The entire capital stock of Refining Company, evidencing equity ownership in the Bradstreet properties and the cracking plant, was transferred to Standard. Thus, on the face of things, Standard, through ownership of the capital stock of Refining Company, owned and controlled the Bradstreet properties and the cracking plant and put itself in such a position that, without its continued cooperation, Deep Rock could not function.

As at October 1, 1925, but in fact somewhat later, at the dictation of Standard's officials, a lease was executed by the Refining Company to Deep Rock covering the properties in question whereby Deep Rock should, for the first three months, pay $75,000 per month and, for the ensuing four and three-quarters years, pay $50,000 a month to Refining Company as rental. Such rental as was paid by Deep Rock was at once declared by Refining Company as a dividend to Standard and such as was not paid was debited to Deep Rock by Standard in the open account. Under this lease, which expired October 1, 1930, Deep Rock paid, or became obligated to Standard in the total of, $3,075,000. During the term of the lease the operations of the leased properties showed a net loss of $30,401.40. The lease further provided that Deep Rock, at its own cost, should make all improvements and additions to the leased property, should make good all depreciation and return the property in the same condition as when leased. Additions to the cracking plant cost Deep Rock, during the term, $264,680.51; and there were charged against Deep Rock in alleged fulfilment of its obligations under the lease, taxes of Refining Company and other items amounting to $192,415.91. Meantime, in two letters written bankers in connection with the sale of notes of Deep Rock, the president of Deep Rock, who was also president of Standard, made statements, and warranted their truth, to the effect that Deep Rock owned these leased properties.

In spite of the losses entailed upon Deep Rock by the lease arrangement, Standard dictated its renewal for another term of five years commencing October 1, 1930, and from that date to the receivership Deep Rock paid, or was debited by Standard with, $1,450,000, as rental and suffered, in the operation of the properties leased, a total loss of $1,584,458.05. During the combined terms of the two leases Deep Rock was charged in the open account for Standard's subsidiary management corporation in payment of managerial, engineering, and financial advice, $1,020,000.

Immediately after the last and presently outstanding note issue was sold to the public Standard's annual report, for the first time, disclosed its claim to the ownership of the Refining Company properties. At the date of the receivership Standard claimed it owned the Refining Company's properties through stock ownership, and held its note in the amount of $1,894,592.11. The trustee in bankruptcy attacked this transaction as fraudulent and asserted Deep Rock's ownership of all the property represented by the Refining Company's stock free of any indebtedness to Standard in respect of it.

During the whole period from 1919 to the receivership, Standard charged Deep Rock interest at the rate of seven per cent. per annum compounded monthly on the balance shown by the open account. During the entire period the Management Corporation charged Deep Rock with round annual sums for management and supervision of Deep Rock's affairs which totaled $1,219,034.83, all of which Standard assumed and charged into the open account.

It is impossible within the compass of this opinion to detail the numerous other transactions evidenced by the books of the two companies many of which were to the benefit of Standard and to the detriment of Deep Rock. All of them were accomplished through the complete control and domination of Standard and without the participation of the preferred stockholders who had no voice or vote in the management of Deep Rock's affairs.[4]

The suggested basis of compromise of Standard's claim needs comment. As has been said, when, in 1928, it became necessary to refinance Deep Rock's note obligations, Standard had to wipe out the enormous and threatening credit balance in its favor on Deep Rock's books. It, therefore, took common stock in payment of the balance. It is said that the compromise figure is reached by disregarding all transactions prior to February 24, 1928, when Standard commuted its then claim, starting fresh from that date, and considering only the items in the account thenceforward to the date of receivership. It is asserted that, during the period in question, Standard paid out, for account of Deep Rock, in cash, $6,850,971.50 and credited Deep Rock against these expenditures $4,475,803.59, leaving a balance of cash advanced of $2,375,167.91, as to which there can be no question; the Bradstreet properties and the cracking plant are to be returned to Deep Rock's ownership by transfer of the stock of the Refining Company and its note now held by Standard. It is asserted that in consideration of this transfer Deep Rock ought to assume the original cost of the Bradstreet properties advanced by Standard ($650,000), plus the amount of the disbursements by Deep Rock upon those properties which Standard had credited to Deep Rock when it took over the Refining Company stock ($1,894,592.11), less rentals charged by the Refining Company to Deep Rock prior to February 24, 1928, which rentals had been absorbed in the settlement by Stand-

[4] At no time did the charter confer voting power on preferred stockholders, except in case and so long only as the company should be in default in payment of dividends on the preferred for a period of more than six months. At no time did Standard have less than a majority of the voting stock outstanding.

ard of February 24, 1928 ($1,475,000). This leaves Deep Rock owing on the Bradstreet and cracking plant accounts $1,585,485.18. Simple interest at five per cent. is to be allowed on each of the two sums so ascertained. This brings the claim to approximately $5,000,000. It is said that this computation of the claim eliminates debits to Deep Rock made since 1928 for the fees of Management Corporation, for dividends on preferred and common stock held by Standard, and for every other questionable item; and that there can be no just criticism of the recognition of Standard's claim in the amount represented by the compromise offer.

Petitioners invoke the so-called instrumentality rule,—under which, they say, Deep Rock is to be regarded as a department or agent of Standard,—to preclude the allowance of Standard's claim in any amount. The rule was much discussed in the opinion below. It is not, properly speaking, a rule, but a convenient way of designating the application, in particular circumstances, of the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice. This principle has been applied in appropriate circumstances to give minority stockholders redress against wrongful injury to their interests by a majority stockholder.[5] It must be apparent that the preferred stockholders of Deep Rock assert such injury by Standard as the basis of their attack on the decree below. We need not stop to discuss the remedy which would be available to them if Section 77B of the Bankruptcy Act had not been adopted for we think that, by that section, the court, in approving a plan, was authorized and required, as a court of equity, to recognize the rights and the status of the preferred stockholders arising out of Standard's wrongful and injurious conduct in the mismanagement of Deep Rock's affairs.

The Section contains a provision new in bankruptcy legislation with respect to the standing of stockholders in corporate reorganization. Subsection (b) provides: "A plan of reorganization * * * (2) may include provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character or otherwise; * * *." In the present case there remains an equity after satisfaction of the creditors in which only the preferred stockholders and Standard can have an interest. Equity requires the award to preferred stockholders of a superior position in the reorganized company. The District Judge, we think, properly exercised his discretion in refusing to approve the first offer of compromise and concomitant plan because it partly subordinated preferred stockholders to Standard. The same considerations which moved him to reject that plan required the rejection of the new offer and the amended plan.

Deep Rock finds itself bankrupt not only because of the enormous sums it owes Standard but because of the abuses in management due to the paramount interest of interlocking officers and directors in

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5 Compare Southern Pacific Co. v. Bogert, 250 U.S. 483, 39 S.Ct. 533, 63 L.Ed. 1099, infra, p. 1221.

the preservation of Standard's position, as at once proprietor and creditor of Deep Rock. It is impossible to recast Deep Rock's history and experience so as even to approximate what would be its financial condition at this day had it been adequately capitalized and independently managed and had its fiscal affairs been conducted with an eye single to its own interests. In order to remain in undisturbed possession and to prevent the preferred stockholders having a vote and a voice in the management, Standard has caused Deep Rock to pay preferred dividends in large amounts. Whatever may be the fact as to the legality of such dividends judged by the balance sheets and earnings statements of Deep Rock, it is evident that they would not have been paid over a long course of years by a company on the precipice of bankruptcy and in dire need of cash working capital. This is only one of the aspects in which Standard's management and control has operated to the detriment of Deep Rock's financial condition and ability to function. Others are apparent from what has been said and from a study of the record.

If a reorganization is effected the amount at which Standard's claim is allowed is not important if it is to be represented by stock in the new company, provided the stock to be awarded it is subordinated to that awarded preferred stockholders. No plan ought to be approved which does not accord the preferred stockholders a right of participation in the equity in the Company's assets prior to that of Standard, and at least equal voice with Standard in the management. Anything less would be to remand them to precisely the status which has inflicted serious detriment on them in the past.

Reversed.

MR. JUSTICE FRANKFURTER took no part in the consideration or decision of this case.

PART II

CAPITAL STOCK AND ITS PROPERTY OR CONTRACT RIGHTS

SOCIAL CHANGE IN PROPERTY

The advent of the modern corporation as a means of doing business has had a profound effect on the institution of private property. Its full impact is not yet realized and still less its ultimate implication.

Its effect was to diffuse the atom of property into its various component protons, neutrons and electrons, but to keep them in relation to each other by a nucleus of management.

Before corporations became general, property was a tight bundle of rights establishing an immediate, direct, continuous relationship between an owner and a tangible (or, perhaps, intangible) *res*. A farm, or a forge, was actually possessed by its owner. He could do things to it, or with it; from the things he did, he might derive support or shelter or profit or satisfaction. He had title to it, he managed it, he occupied it, or could do so; the property contributed to his personality, and he contributed to the characteristics which the property assumed. Both economically and psychologically it brought the owner into a definite relationship with the thing. Out of this grew social relationships as well as economic relationships.

But, during the past century, the corporation has become dominant as a vehicle for the ownership and conduct of most business except agriculture, and is even making inroads there. Especially when the corporation attains any size, or the stockholder-owners become numerous, the old tight relationship is dissolved. In a large corporation, the relations have become so tenuous as to be almost invisible. Thus, the stockholder no longer has title to the corporate property. He has title to a share of stock. He no longer manages the corporate property. He votes (by proxy) for directors, whom he rarely knows. Probably he never sees the enterprise. His ownership in the stock gives him no right to have a job with the corporation.

The management has the right to establish policies, make decisions and handle the affairs, internal and external, of the corporation. They do not "own" the corporate property; nor have any necessary permanent relationship to it. Frequently they are not even stockholders or have such insignificant holdings of the stock that their motives differ widely from owners. Whereas the owner is guided by the desire to seek the largest profit from his property, the management, not being owner, do not have this incentive. Their incentive may be to maintain their jobs; or to increase the scope of the corporation so that their own importance is enhanced; or to pioneer new fields of technical development;—in other words, they have more nearly the motivations of good or bad men in public office than those of owners.

Except as labor contracts or special arrangements may exist, the people who work in and about the corporate property and enterprise have no permanent interest in it and no permanent relation to it. They have, of course, vivid interest in having jobs which pay them adequately and satisfy the human need to be an active part of civilization. The corporation affords them opportunity to do this while it is active; but as a rule undertakes no permanent responsibility to them—the relationship can be terminated almost at will by either party, subject to such limitations as may arise from labor organizations and renewal of contracts. The owner-laborer has disappeared.

Likewise the customer or patron who relies on the corporation or its competitors to supply him with certain kinds of goods and services has merely the relationship of habit, and of profitable intercourse. The corporation, outside the public utility field, is not normally bound to go on supplying customers but may shut down at will. The customer is not obligated to buy from the corporation; he may take his trade elsewhere. The owner who enjoyed the product or shelter or facilities of the farm or forge has likewise disappeared.

From the middle of the 19th to the middle of the 20th Century, nearly half of the entire national wealth of the United States changed from the possessor-ownership form of property into the corporate form. Rarely, if ever, in history has so great a change taken place without violence, or have the relationships of great masses of people to physical property, and its companion, intangible technical process and knowledge, altered so profoundly.

Corporation law has dealt with these changes piece-meal, and has not yet fully systematized them. The lines of corporation law affecting corporation management are reasonably well blocked out. So too there is an elaborate body of law relating to stockholders, though this appears to be shifting emphasis rather rapidly. There is still doubt as to whether the law will crystallize around the concept of a stockholder as part-owner, or around the idea that the stockholder has merely a specialized form of contract right.

The line of development affecting the relative rights of customers and the corporate supplier has followed the line of the old commercial law. Even as to that, Professor Bruce Wyman more than thirty years ago made a valiant argument in the last volume of his book on "Public Utilities" for the proposition that a corporation which achieved substantial monopoly, should be held to the standards of, and regulated as, a public utility.

The legal rules affecting relations between a corporation and its labor are still in their infancy. These two categories, i.e., corporation and customer, and corporation and labor, do not enter into these materials, and are not considered a part of the corporation field though plainly both are powerfully affected by the new form of property and enterprise organization.

* * * * * *

The aggregated enterprise is summarized by its statements (balance sheet, income statement) showing what property it has and the claims against that property; and the financial results of its operations. To these we first turn. They hardly suggest the depth of the actual social drama.

The Typical Manufacturing Company, Inc.

CONSOLIDATED BALANCE SHEET—DECEMBER 31, 1946

ASSETS

Item			
1	CURRENT ASSETS:		
2	Cash		$ 2,000,000
3	U. S. Government Securities		1,000,000
4	Accounts Receivable (less reserves)		2,000,000
5	Inventories (at lower of cost or market)		2,000,000
6	TOTAL CURRENT ASSETS		$ 7,000,000
7	INVESTMENT IN AFFILIATED COMPANY— Not consolidated (at cost, not in excess of net assets)		200,000
8	OTHER INVESTMENTS—AT COST, less than market		100,000
9	PLANT IMPROVEMENT FUND		550,000
10	PROPERTY, PLANT AND EQUIPMENT: Cost	$8,000,000	
11	Less Reserve for Depreciation	5,000,000	
12	NET PROPERTY		$ 3,000,000
13	PREPAYMENTS		50,000
14	DEFERRED CHARGES		100,000
15	PATENTS AND GOODWILL		100,000
	TOTAL		$11,100,000

LIABILITIES

Item			
16	CURRENT LIABILITIES:		
17	Accounts Payable		$ 300,000
18	Accrued Taxes		800,000
19	Accrued Wages, Interest and other Expenses		370,000
20	TOTAL CURRENT LIABILITIES		$ 1,470,000
21	FIRST MORTGAGE SINKING FUND BONDS, 3½% DUE 1966		2,000,000
22	RESERVE FOR CONTINGENCIES		200,000
23	CAPITAL STOCK:		
24	5% Preferred Stock (authorized and issued 10,000 shares of $100 par value)	$1,000,000	
25	Common Stock (authorized and issued 400,000 shares of no par value)	1,000,000	2,000,000
26	SURPLUS:		
27	Earned	$3,530,000	
28	Capital (arising from sale of common capital stock at price in excess of stated value)	1,900,000	5,430,000
	TOTAL		$11,100,000

HOW TO READ A FINANCIAL REPORT[1]

* * * The balance sheet represents the situation as it stood on one particular day, December 31, 1946, not the record of a year's operation. This balance sheet is broken into two parts; on the left are shown "Assets" and on the right "Liabilities." Under the asset column you will find listed the value of things the company *owns* or are *owed to* the company. Under liabilities, are listed the things the company owes to others, *plus* reserves, surplus and the stated value of the stockholders' interest in the company. * * *

ASSETS

The first notation on the asset side of the balance sheet is "Current Assets" (item 1). In general, current assets include cash and things that can be turned into cash in a hurry, or that in the normal course of business will be turned into cash in the reasonably near future, usually within a year.

Item 2 on our sample sheet is "Cash." Cash is just what you would expect—bills and silver in the till and money on deposit in the bank.

"United States Government Securities," is item 3. The general practice is to show securities listed as current assets at cost or market value, whichever is lower. The figure, for all reasonable purposes, represents the amount by which total cash could be easily increased if the company wanted to sell these securities.

The next entry is "Accounts Receivable" (item 4). Here we find the total amount of money owed to the company by its regular business creditors and collectible within the next year. Most of the money is owed to the company by its customers for goods that the company delivered on credit. If this were a department store instead of a manufacturer, what you owed the store on your charge account would be included here. Because some people fail to pay their bills, the company sets up a reserve for doubtful accounts which it subtracts from *all* the money owed.

Item 5, "Inventories", is the value the company places on the supplies it owns. The inventory of a manufacturer may contain raw materials that it uses in making the things it sells, partially finished goods in process of manufacture and, finally, completed merchandise that is ready to sell. Several methods are used to arrive at the value placed on these various items. The most common is to value them at their cost or present market value, whichever is lower. You can be reasonably confident, however, that the figure given is an honest and significant one for the particular industry if the report is certified by a reputable firm of public accountants.

Next on the asset side is "Total Current Assets" (item 6). This is an extremely important figure when used in connection with other

[1] Excerpts, courtesy Merrill Lynch, Pierce, Fenner & Beane, 1947.

items in the report, which we will come to presently. Then we will discover how to make total current assets tell their story.

"Investment in Affiliated Company" (item 7), represents the cost to our parent company of the capital stock of its subsidiary or affiliated company. A subsidiary is simply one company that is controlled by another. Most corporations that own other companies outright, lump the figures in a "Consolidated Balance Sheet." This means that under cash, for example, one would find a total figure that represented all of the cash of the parent company and of its wholly owned subsidiary. This is a perfectly reasonable procedure because, in the last analysis, all of the money is controlled by the same persons.

Our typical company shows that it has "Other Investments" (item 8), in addition to its affiliated company. Sometimes good marketable securities other than Government bonds are carried as current assets, but the more conservative practice is to list these other security holdings separately. If they have been bought as a permanent investment they would always be shown by themselves. "At cost, less than market" means that our company paid $100,000 for these other investments, but they are now worth more.

Among our assets is a "Plant Improvement Fund" (item 9). Of course, this item does not appear in all company balance sheets, but is typical of special funds that companies set up for one purpose or another. For example, money set aside to pay off part of the bonded debt of a company might be segregated into a special fund. The money our directors have put aside to improve the plant would often be invested in Government bonds.

FIXED ASSETS

The next item (10), is "Property, Plant and Equipment," but it might just as well be labeled "Fixed Assets" as these terms are used more or less interchangeably. Under item 10 the report gives the value of land, buildings and machinery and such movable things as trucks, furniture and hand tools. Historically, probably more sins were committed against this balance sheet item than any other.

In olden days, cattlemen used to drive their stock to market in the city. It was a common trick to stop outside of town, spread out some salt for the cattle to make them thirsty and then let them drink all the water they could hold. When they were weighed for sale the cattlemen would collect cash for the water the stock had drunk. Business buccaneers, taking the cue from their farmer friends, would often "write up" the value of their fixed assets. In other words, they would increase the value shown on the balance sheet, making the capital stock appear to be worth a lot more than it was. "Watered Stock" proved a bad investment for most stockholders. The practice has, fortunately, been stopped, though it took major financial reorganizations to squeeze the water out of some securities.

The most common practice today is to list fixed assets at cost. Often, there is no ready market for most of the things that fall

under this heading, so it is not possible to give market value. A good report will tell what is included under fixed assets and how it has been valued. If the value has been increased by "write-up" or decreased by "write-down," a footnote explanation is usually given. A "write-up" might occur, for instance, if the value of real estate increased substantially. A "write-down" might follow the invention of a new machine that put an important part of the company's equipment out of date.

DEPRECIATION

Naturally, all of the fixed property of a company will wear out in time (except, of course, non-agricultural land). In recognition of this fact, companies set up a "Reserve for Depreciation" (item 11). If a truck costs $4,000 and is expected to last four years, it will be depreciated at the rate of $1,000 a year.

Two other terms also frequently occur in connection with depreciation—"depletion" and "obsolescence." Companies may lump depreciation, depletion and obsolescence under a single title, or list them separately.

"Depletion" is a term used primarily by mining and oil companies (or any of the so-called extractive industries). Depletion means exhaust or use up. As the oil or other natural resource is used up, a reserve is set up to compensate for the natural wealth the company no longer owns. This reserve is set up in recognition of the fact that as the company sells its natural product it must get back not only the cost of extracting, but also the original cost of the natural resource.

"Obsolescence" represents the loss in value because a piece of property has gone out of date before it wore out. Airplanes are modern examples of assets that tend to get behind the times long before the parts wear out.

In our sample balance sheet we have placed the reserve for depreciation under fixed assets and then subtracted, giving us "Net Property" (item 12), which we add into the asset column. Sometimes, companies put the reserve for depreciation in the liability column. As you can see, the effect is just the same whether it is subtracted from assets or added to liabilities.

The manufacturer, whose balance sheet we use, rents a New York showroom and pays his rent yearly, in advance. Consequently, he has listed under assets "Prepayments" (item 13). This is listed as an asset because he has paid for the use of the showroom, but has not yet received the benefit from its use. The use is something coming to the firm in the following year and, hence, is an asset. The dollar value of this asset will decrease by one-twelfth each month during the coming year.

"Deferred Charges" (item 14), represents a type of expenditure similar to prepayment. For example, our manufacturer brought out a new product last year, spending $100,000 introducing it to the market. As the benefit from this expenditure will be returned over

months or even years to come, the manufacturer did not think it reasonable to charge the full expenditure against costs during 1946. He has "deferred" the charges and will write them off gradually.

INTANGIBLES

The last entry in our asset column is "Patents and Goodwill" (item 15). If our company was a young one, set up to manufacture some new patented product, it would probably carry its patents at a substantial figure. In fact, "intangibles" of both old and new companies are often of great but generally unmeasurable worth.

Company practice varies considerably in assigning value to intangibles. Procter & Gamble, despite the tremendous goodwill that has been built up for "Ivory Soap," has reduced all of its intangibles to the nominal $1. Some of the big cigarette companies, on the contrary, place a high dollar value on the goodwill their brand names enjoy. Companies that spend a lot for research and the development of new products are more inclined than others to reflect this fact in the value assigned to patents, license agreements, etc.

LIABILITIES

The liability side of the balance sheet is a little tricky at first glance. Several of the entries don't sound like liabilities by ordinary definition of the term.

The first item on the liability side of any balance sheet is usually "Current Liabilities" (item 16). This is a companion to the "Current Assets" item across the page and includes all debts that fall due within the next year. The relation between current assets and current liabilities is one of the most revealing things to be gotten from the balance sheet, but we will go into that quite thoroughly later on.

"Accounts Payable" (item 17), represents the money that the company owes to its ordinary business creditors—unpaid bills for materials, supplies, insurance and the like. Many companies itemize the money they owe in a much more detailed fashion than we have done, but, as you will see, the totals are the most interesting thing to us.

Item 18, "Accrued Taxes," is the tax bill that the company estimates it still owes for the past year, 1946. We have lumped all taxes in our balance sheet, as many companies do. However, sometimes you will find each type of tax given separately. If the detailed procedure is followed, the description of the tax is usually quite sufficient to identify the separate item.

Accounts Payable was defined as the money the company owed to its regular business creditors. The company also owes, on any given day, wages to its own employees; interest to its bondholders and to banks from which it may have borrowed money; fees to its attorneys; pensions, etc. These are all totaled under "Accrued Wages, Interest and Other Expenses" (item 19).

"Total Current Liabilities" (item 20) is just the sum of everything that the company owed on December 31 and which must be paid sometime in the next twelve months.

It is quite clear that all of the items discussed above are liabilities. The rest of the entries on the liability side of the balance sheet, however, do not seem at first glance to be liabilities.

Our balance sheet shows that the company, on December 31, had \$2,000,000 of 3½ per cent First Mortgage Bonds outstanding (item 21). Legally, the money received by a company when it sells bonds is considered a loan to the company. Therefore, it is obvious that the company owes to the bondholders an amount equal to the face value or the "call price" of the bonds it has outstanding. The call price is a figure usually larger than the face value of the bonds at which price the company can "call" the bonds in from the bondholders and pay them off before they ordinarily fall due. The date that often occurs as part of the name of a bond is the date at which the company has promised to pay off the loan from the bondholders.

RESERVES

The next heading, "Reserve for Contingencies" (item 22), sounds more like an asset than a liability. "My reserves," you might say, "are dollars in the bank and dollars in the bank are assets."

In fact, the corporation treasurer also has his reserve for contingencies balanced by either cash or some kind of unspecified investment on the asset side of the ledger. His reason for setting up a reserve on the liability side of the balance sheet is a precaution against making his financial position seem better than it is. He decided that the company might have to pay out this money during the coming year if certain things happen. If he did not set up the "reserve" his surplus would appear larger by an amount equal to his reserve.

A very large reserve for contingencies or a sharp increase in this figure from the previous year should be examined closely by the investor. Often in the past companies tried to hide their true earnings by transferring funds into a contingency reserve. As a reserve looks somewhat like a true liability, stockholders were confused about the real value of their securities. When a reserve is not set up for protection against some very probable loss or expenditure it should be considered by the investor as part of surplus.

CAPITAL STOCK

Below reserves there is a major heading: "Capital Stock" (item 23). Companies may have one type of security outstanding, or they may have a dozen. All of the issues that represent shares of ownership are capital, regardless of what they are called on the balance sheet—preferred stock, preference stock, common stock, founders' shares, capital stock, or something else.

Our typical company has one issue of 5 per cent "Preferred Stock" (item 24). It is called "preferred" because those who own it have a right to dividends and assets before the "common" stockholders—that is, the holders are in a preferred position as owners. Usually preferred stockholders do not have a voice in company affairs unless the company fails to pay them dividends at the promised rate. Their

rights to dividends are almost always "cumulative." This simply means that all past dividends must be paid before the other stockholders can receive anything.

Preferred stockholders are not creditors of the company so it cannot properly be said that the company "owes" them the value of their holdings. However, in case the company decided to go out of business, preferred stockholders would have a prior claim on anything that was left in the company treasury after all of the creditors, including the bondholders, were paid off. In practice, this right does not always mean much, but it does explain why the book value of their holdings is carried as a liability.

"Common Stock" (item 25) is simple enough as far as definition is concerned—it represents the rights of the ordinary owner of the company. Each company has as many owners as it has stockholders. The proportion of the company that each stockholder owns is determined by the number of shares he has. However, neither the book value of a no-par common stock, nor the par value of an issue that has a given par, can be considered as representing either the original sale price, the market value or what would be left for the stockholders if the company were liquidated.

A profitable company would seldom be dissolved. Once things have taken such a turn that dissolution appears desirable, the stated value of the stock is generally nothing but a fiction. Even if the company is profitable as a going institution, once it ceases to function even its tangible assets drop in value because there is not usually a ready market for its inventory of raw materials and semi-finished goods, or its plant and machinery.

SURPLUS

The last major heading on the liability side of the balance sheet is "Surplus" (item 26). The surplus, of course, is not a liability in the popular sense at all. It represents, on our balance sheet, the difference between the stated value of common stock and the net assets behind the stock.

Two different kinds of surplus frequently appear on company balance sheets and our company has both kinds. The first type listed is "Earned" surplus (item 27). Earned surplus is roughly similar to your own savings. To the corporation, earned surplus is that part of net income which has not been paid to stockholders as dividends. It still "belongs" to the stockholders just as your savings account belongs to you, but the directors have decided that it is best for the company and the stockholders to keep it in the business. The surplus may be invested in the plant just as you might invest part of your savings in your home. It may also be in cash or securities.

In addition to the earned surplus, our company also has a "Capital" surplus (item 28), of $1,900,000, which the balance sheet explains arose from selling the stock at a higher cost per share than is given as its stated value. A little arithmetic shows that the stock is carried on the books at $2.50 a share while the capital surplus amounts

to $4.75 a share. From this we know that the company actually received an average of $7.25 net a share for the stock when it was sold. * * *

The Typical Manufacturing Company, Inc.

CONSOLIDATED INCOME AND EARNED SURPLUS

For the Year Ended December 31, 1946

Item			
a	NET SALES		$10,000,000
b	COST OF SALES, EXPENSES AND OTHER OPERATING CHARGES:		
c	Cost of Goods Sold	$7,000,000	
d	Selling, Administrative and General Expenses	500,000	
e	Depreciation	200,000	
f	Maintenance and Repairs	400,000	
g	Taxes (Other Than Federal Income Taxes)	300,000	8,400,000
h	NET PROFIT FROM OPERATIONS		$ 1,600,000
i	OTHER INCOME:		
j	Royalties and Dividends	$ 250,000	
k	Interest	25,000	275,000
l	TOTAL		$ 1,875,000
m	INTEREST CHARGES:		
n	Interest on Funded Debt	$ 70,000	
o	Other Interest	20,000	90,000
p	NET INCOME BEFORE PROVISION FOR FEDERAL INCOME TAXES		$ 1,785,000
q	PROVISION FOR FEDERAL INCOME TAXES		678,300
r	NET INCOME		$ 1,106,700
s	DIVIDENDS:		
t	Preferred Stock—$5.00 Per Share	$ 50,000	
u	Common Stock—$1.00 Per Share	400,000	
v	PROVISION FOR CONTINGENCIES	200,000	650,000
w	BALANCE CARRIED TO EARNED SURPLUS		$ 456,700
x	EARNED SURPLUS—January 1, 1946		3,073,300
y	EARNED SURPLUS—DECEMBER 31, 1946		$ 3,530,000

THE INCOME ACCOUNT

The fundamental soundness of a company, as shown by its balance sheet, is important to investors, but of even greater interest is the record of its operation. Its financial structure shows much of its ability to weather storms and pick up speed when times are good. It is the income record, however, that shows us how a company is actually doing and gives us our best guide to the future. * * *

We have used a combined income and surplus account because that is the form most frequently followed by industrial companies. However, sometimes the two statements are given separately. Also, a variety of names are used to describe this same part of the financial report. Sometimes it is called "profit and loss account," sometimes "record of earnings" and often simply "income account." They are all the same animal.

The details that you will find on different income statements also vary a great deal. Some companies show only eight or ten separate items, while others will give a page or more of closely spaced entries that break down each individual type of revenue or cost. We have tried to strike a balance between extremes; give the major items that are in most income statements, omitting details that are only interesting to the expert analyst.

The most important source of revenue always makes up the first item on the income statement. In our company it is "Net Sales" (item "a"). If it were a railroad or a utility instead of a manufacturer, this item would be called "gross revenues." In any case it represents the money paid into the company by its customers. Net sales are given to show that the figure represents the amount of money actually received after allowing for discounts and returned goods.

Net sales or gross revenues, you will note, is given before any kind of miscellaneous revenue that might have been received from investments, the sale of company property, tax refunds or the like. A well prepared income statement is always set up this way so that the stockholder can estimate the success of the company in fulfilling its major job of selling goods or service. If this were not so, you could not tell whether the company was really losing or making money on its operations, particularly over the last few years when tax rebates and other unusual things have often had great influence on final net income figures.

COST OF SALES

A general heading, "Cost of Sales, Expenses and Other Operating Charges" (item "b") is characteristic of a manufacturing company, but a utility company or railroad would call all of these things "operating expenses."

The most important subdivision is "Cost of Goods Sold" (item "c"). Included under cost of goods sold are all of the expenses that go directly into the manufacture of the products the company sells—raw materials, wages, freight, power and rent. We have lumped these expenses together, as many companies do. Sometimes, however, you will find each item listed separately. Analyzing a detailed income account is a pretty technical operation and had best be left to the expert.

We have shown separately, opposite "d," the "Selling, Administrative and General Expenses" of the past year. Unfortunately, there is little uniformity among companies in their treatment of these important non-manufacturing costs. Our figure includes the expenses

of management, that is, executive salaries and clerical costs; commissions and salaries paid to salesmen; advertising expenses, and the like.

"Depreciation" ("e") shows us the amount that the company transferred from income during 1946 to the depreciation reserve that we ran across before as item 11 on the balance sheet (page 4). Depreciation must be charged against income unless the company is going to live on its own fat; something that no company can do for long and stay out of bankruptcy.

MAINTENANCE

"Maintenance and Repairs" (item "f") represents the money spent to keep the plant in good operating order. For example, the truck that we mentioned under depreciation must be kept running day by day. The cost of new tires, recharging the battery, painting and mechanical repairs are all maintenance costs. Despite this day-to-day work on the truck, the company must still provide for the time when it wears out—hence, the reserve for depreciation. * * *

Taxes, * * * A profitable company always pays at least two types of taxes. One group of taxes are paid without regard to profits and include real estate taxes, excise taxes, social security and the like (item "g"). As these payments are a direct part of the cost of doing business, they must be included before we can determine the "Net Profit From Operations" (item "h").

Net profit from operations (sometimes called "gross profit") tells us what the company made from manufacturing and selling its products. It is an interesting figure to investors because it indicates how efficiently and successfully the company operates in its primary purpose as a creator of wealth. As a glance at the income account will tell you, there are still a lot of other items to be deducted before the stockholder can hope to get anything. You can also easily imagine that for many companies these other items may spell the difference between profit and loss. For these reasons we use net profit from operations as an indicator of progress in manufacturing and merchandising efficiency, not as a judge of the investment quality of securities.

Miscellaneous income not connected with the major purpose of the company is generally listed after net profit from operations. There are quite a number of ways that corporations increase their income, including interest and dividends on securities they own, fees for special services performed, royalties on patents they allow others to use and, recently, tax refunds. Our income statement shows "Other Income" as item "i," under which is shown income from "Royalties and Dividends" (item "j") and, as a separate entry, "Interest" (item "k") which the company received from its bond investments. The "Total" of other income (item "l") shows us how much the Typical Manufacturing Company received from so-called "outside" activities. Corporations with diversified interests often receive tremendous amounts of "other income."

INTEREST CHARGES

There is one other class of expenses that must be deducted from our income before we can determine the base on which taxes are paid and that is "Interest Charges" (item "m"). As our company has $2,000,000 worth of 3½ per cent bonds outstanding, it will pay "Interest on Funded Debt" of $70,000 (item "n"). During the year the company also borrowed money from the bank on which it, of course, paid interest, shown as "Other Interest" (item "o").

"Net Income Before Provision for Federal Income Taxes" (item "p"), is an interesting figure for historical comparison. It shows us how profitable the company was in all of its various operations. A comparison of this entry over a period of years will enable you to see how well the company had been doing as a business institution before the Government stepped in for its share of net earnings. Federal taxes have varied so much in recent years that earnings before taxes are often a real help in judging business progress.

A few paragraphs back we mentioned that a profitable corporation pays two general types of taxes. We have already discussed those that are paid without reference to profits. "Provision for Federal Income Taxes" (item "q") is ordinarily figured on the total income of the company after normal business expenses, so appears on our income account below these charges. Bond interest, for example, as it is payment on a loan, is deducted beforehand. Preferred and common stock dividends, which are "profits" that go to owners of the company, come after all charges and taxes.

NET INCOME

After we have deducted all of our expenses and income taxes from total income we get "Net Income" (item "r"). Net income is the most interesting figure of all to the investor. Net income is the amount available to pay dividends on the preferred and common stock. From the balance sheet we have learned a good deal about the company's stability and soundness of structure; from net profit from operations we judge whether the company is improving in industrial efficiency. Net income tells us whether the securities of the company are likely to be a profitable investment. * * *

The investor in stocks has a vital interest in "Dividends" (item "s"). The first dividend that our company must pay is that on its "Preferred Stock" (item "t"). Some companies will even pay preferred dividends out of earned surplus accumulated in the past if the net income is not large enough, but such a company is skating on thin ice unless the situation is most unusual.

The directors of our company decided to pay dividends totaling $400,000 on the "Common Stock," or $1 a share (item "u"). As we have noted before, the amount of dividends paid is not determined by net income, but by a decision of the stockholders' representatives —the company directors. Common dividends, just like preferred dividends, can be paid out of surplus if there is little or no net income. Sometimes companies do this if they have a long history of regular payments and don't want to spoil the record because of some

special temporary situation that caused them to lose money. This occurs even less frequently and is more "dangerous" than paying preferred dividends out of surplus.

It is much more common, on the contrary, to "plough earnings back into the business"—a phrase you frequently see on the financial pages and in company reports. The directors of our typical company have decided to pay only $1 on the common stock, though net income would have permitted them to pay much more. They decided that the company should "save" the difference.

The next entry on our income account, "Provision for Contingencies" (item "v"), shows us where our reserve for contingencies arose. The treasurer of our typical company has put the provision for contingencies after dividends. However, you will discover, if you look at very many financial reports, that it is sometimes placed above net income.

All of the net income that was not paid out as dividends or set aside for contingencies is shown as "Balance Carried to Earned Surplus" (item "w"). In other words, it is kept in the business. In previous years the company had also earned more than it paid out so it has already accumulated by the beginning of 1946 an earned surplus of $3,073,300 (item "x"). When we total the earned surplus accumulated during 1946 to that which the company had at the first of the year, we get the total earned surplus at the end of the year (item "y"). You will notice that the total here is the same as that which we ran across on the balance sheet as item 27.

Not all companies combine their income and surplus account. When they do not, you will find that "balance carried to surplus" will be the last item on the income account. The statement of consolidated surplus would appear as a third section of the corporation's financial report. A separate surplus account might be used if the company shifted funds for reserves to surplus during the year or made any other major changes in its method of treating the surplus account. * * *

RADIO CORPORATION OF AMERICA AND DOMESTIC SUBSIDIARIES
STATEMENTS OF CONSOLIDATED INCOME AND EARNED SURPLUS FOR THE YEARS ENDED DECEMBER 31, 1946 AND 1945

	Amount per share	Year ended Dec. 31, 1946	Year ended Dec. 31, 1945
GROSS INCOME:			
From Operations		$236,145,728	$278,327,902
Other Income, including Interest and Dividends from Other Investments		835,042	1,091,264
Dividends from Foreign Subsidiaries (Note 2)		—	84,449
TOTAL GROSS INCOME FROM ALL SOURCES		$236,980,770	$279,503,615
Deduct:			
Cost of Goods Sold, General Operating, Development, Selling and Administrative Expenses (Note 7)		$219,160,007	$244,317,196
Depreciation (Note 8)		2,243,439	3,317,943
Amortization of Patents		1,000,000	900,000
Interest		230,971	484,408
TOTAL		$222,634,417	$249,019,547
BALANCE BEFORE PROVISION FOR FEDERAL TAXES ON INCOME AND SPECIAL CHARGES FOR RECONVERSION EXPENSES		$ 14,346,353	$ 30,484,068
Deduct:			
Provision for Federal Income Taxes (including $9,762,000 for Excess Profits Tax in 1945)		$ 4,673,300	$ 14,683,000
Less:			
Estimated Recovery of Prior Years' Excess Profits Tax Resulting from Carry-back of Unused Excess Profits Tax Credit		3,108,000	1,485,000
NET TAXES (Note 3)		$ 1,565,300	$ 13,198,000
Portion of Expenses (Totaling $5,858,505 for 1946 and $7,252,279 for 1945) incurred for postwar reconversion, being the amount of the related tax reduction (The balance was charged to the Reserve for Postwar Rehabilitation and Other Adjustments of Wartime Costs) (Note 1)		1,796,000	5,969,000
TOTAL DEDUCTIONS (Note 3)		$ 3,361,300	$ 19,167,000
NET INCOME FOR YEAR TRANSFERRED TO EARNED SURPLUS		$ 10,985,053	$ 11,317,068
EARNED SUPLUS AT BEGINNING OF YEAR		49,038,127	43,645,087
		$ 60,023,180	$ 54,962,155
Deduct:			
Dividends:			
On First Preferred Stock	$3.50	$ 3,152,800	$ 3,152,800
On Common Stock	.20	2,771,337	2,771,228
TOTAL DIVIDENDS		$ 5,924,137	$ 5,924,028
EARNED SURPLUS AT END OF YEAR (Notes 5 and 6)		$ 54,099,043	$ 49,038,127

RADIO CORPORATION OF AMERICA AND DOMESTIC SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS AT DECEMBER 31, 1946 AND 1945

Assets

	Dec. 31, 1946	Dec. 31, 1945
CURRENT ASSETS:		
Cash in Banks and on Hand	$ 29,524,845	$ 33,473,686
United States Tax Anticipation Notes and Government Bonds, at Cost	3,432,105	8,539,374
Notes and Accounts Receivable (Less Reserves—1946, $1,808,665; 1945, $1,787,745)	36,842,250	38,295,721
Estimated Recovery of Prior Years Excess Profits Taxes	3,108,000	1,485,000
Inventories (at the Lower of Cost or Market)	55,842,929	37,560,704
TOTAL CURRENT ASSETS	$128,750,129	$119,354,485
INVESTMENTS AND ADVANCES:		
Wholly-owned Foreign Subsidiary Companies (Note 2) (Less Reserves—1946, $1,000,000; 1945, $1,000,000)	$ 2,979,126	$ 2,697,306
Associated and Other Companies, at Cost (Less Reserves—1946, $1,675,543; 1945, $1,686,399)	492,181	492,181
TOTAL INVESTMENTS AND ADVANCES	$ 3,471,307	$ 3,189,487
PLANT AND EQUIPMENT:		
Factories, Radio Communication and Broadcasting Stations, Laboratories, Warehouses, Service Shops, Offices, etc., at cost	$103,174,043	$ 85,075,070
Less: Reserve for Depreciation and Write-down of Plant and Equipment	53,707,290	53,361,225
	$ 49,466,753	$ 31,713,845
PATENTS AND PATENT RIGHTS	$ 14,844,884	$ 14,492,630
Less: Reserve for Amortization	9,890,367	9,900,365
	$ 4,954,517	$ 4,592,265
DEFERRED CHARGES	$ 2,983,541	$ 2,298,766
TOTAL ASSETS	$189,626,247	$161,148,848

Liabilities and Capital

	Dec. 31, 1946	Dec. 31, 1945
CURRENT LIABILITIES:		
Accounts Payable and Accruals	$ 35,835,330	$ 29,475,143
Provision for Federal Taxes on Income (Note 3)	14,669,523	24,033,031
Preferred Dividend Payable	788,200	788,200
Common Dividend Payable	2,771,337	2,771,228
TOTAL CURRENT LIABILITIES	$ 54,064,390	$ 57,067,602

BANK LOANS:		
Notes Due December 30, 1948 under Credit Agreement (Note 6)	$ 30,000,000	--
RESERVE FOR POSTWAR REHABILITATION AND FOR OTHER ADJUSTMENTS OF WARTIME COSTS (Note 1)	—	$ 3,666,345
RESERVE FOR CONTINGENCIES	$ 3,685,040	$ 3,599,000
GENERAL RESERVE	$ 5,441,301	$ 5,441,301
CAPITAL STOCK (Note 4):		
$3.50 Cumulative First Preferred, No Par Value:		
Authorized —920,300 Shares		
Outstanding—900,824 Shares		
At a Stated Value of	$ 14,574,441	$ 14,574,441
(Preference on Involuntary Liquidation $100 per Share or an Aggregate of $90,082,400)		
Common, No Par Value:		
Authorized —18,500,000 Shares		
Outstanding—13,881,016 Shares		
At a Stated Value of	27,762,032	27,762,032
TOTAL CAPITAL STOCK	$ 42,336,473	$ 42,336,473
EARNED SURPLUS (Notes 5 and 6)	$ 54,099,043	$ 49,038,127
TOTAL LIABILITIES AND CAPITAL	$189,626,247	$161,148,848

A. "CAPITAL"

NOTE

After the British Companies Act of 1863, Sir W. S. Gilbert (of Gilbert and Sullivan fame) filed a commentary on the concept of corporate capital, in the form of the following Bab Ballad:

LIMITED LIABILITY

Some seven men form an Association
    (If possible, all Peers and Baronets),
They start off with a public declaration
    To what extent they mean to pay their debts.
That's called their Capital: if they are wary
    They will not quote it at a sum immense.
The figure's immaterial—it may vary
    From eighteen million down to eighteenpence.
        I should put it rather low;
        The good sense of doing so
    Will be evident at once to any debtor.
        When it's left to you to say
        What amount you mean to pay,
    Why, the lower you can put it at, the better.
They then proceed to trade with all who'll trust 'em,
    Quite irrespective of their capital
(It's shady, but it's sanctified by custom);
    Bank, Railway, Loan, or Panama Canal.
You can't embark on trading too tremendous—
    It's strictly fair, and based on common sense—
If you succeed, your profits are stupendous—
    And if you fail, pop goes your eighteenpence.
        Make the money-spinner spin!
        For you only stand to win,
    And you'll never with dishonesty be twitted.
        For nobody can know,
        To a million or so,
    To what extent your capital's committed!
If you come to grief, and creditors are craving
    (For nothing that is planned by mortal head
Is certain in this Vale of Sorrow—saving
    That one's liability is Limited),—
Do you suppose that signifies perdition?
    If so you're but a monetary dunce—
You merely file a Winding-Up Petition,
    And start another Company at once!
        Though a Rothschild you may be
        In your own capacity,
    As a Company you've come to utter sorrow—
        But the Liquidators say,
        "Never mind—you needn't pay,"
    So you start another Company tomorrow!

CAPITAL AND SURPLUS

Business corporations were assumed to be "artificial persons". During the early period of corporation laws, it was inconceivable that an "artificial person" should go into business without some body of assets which could respond to its debts. This presupposition was natural at a time when an individual in business was obliged to subject all of his property to the payment of his debts, and, if that did not suffice, was liable to be imprisoned for any unpaid balance. Corporation laws, then and now, accordingly prescribed that a certain amount of assets should be paid in, and this amount was subject to special rules intended to prevent the corporation from distributing it among its shareholders. In modern terminology, this amount is called the corporation's "capital".

Economists and businessmen have other and probably more exact ideas of what "capital" should be. A businessman will talk usually of the "capital" of an enterprise as including the money raised for more or less permanent investment, where the money is raised by floating a bond issue (which is a debt), or by stock issue, or otherwise. The economist will define "capital" as the assets permanently devoted to the enterprise of production. From the point of view of the lawyer, these definitions are only occasionally relevant.

In earlier days, corporation laws not unusually provided that the corporation should not be allowed to begin business unless and until a statutory minimum amount of "capital stock" had been subscribed and paid for. Only vestigial remnants of their earlier requirement remain in modern corporation laws. Instead modern statutes enact a formula which fixes a method for determining the amount of corporate assets which must be treated as "capital" within the applicable rules.

So long as all shares of stock had a par value the formula was easy. When such stock was issued the corporation was in general obliged to exact payment of not less than such par value; and the "capital" of the corporation (for legal purposes) was defined to be an amount equal to the total par value of all the shares issued. Any balance of assets over that amount (after deducting the amount of any debts) was "surplus".

When, after 1912, statutes permitted issues of stock without par value, the formula had to be elaborated. If nothing was said on the subject, the presumption was (and still is) that all consideration paid for the non-par shares must be considered as "capital", the theory being that the subscriber for these shares made his payment and intended the payment to be permanently devoted to the business, and did not contemplate that part of what he paid in might promptly be redistributed as dividends. At this point, a corporation's capital was an arithmetical figure equal to the aggregate par value of all issued shares having par value, plus all the consideration received for shares without par value.

Businessmen, however, struggled against being limited in this fashion. For various reasons, some legitimate and some not, they increasingly desired to have part of the consideration paid in for shares freed from the limitations which the law throws around statutory "capital". Some wished to start business with "surplus". Accordingly, corporate statutes were revised to permit directors, on the issue of no par stock, to state that a certain amount per share of non-par stock would be regarded as "capital" and any balance over such amount would be regarded as "surplus"—surplus in this context being, of course, merely a part of the consideration received for shares which was not subject to the restriction surrounding capital.

The clearest statutory formula appears in § 12 of the New York Stock Corporation Law (as amended L. of 1945, c. 855, § 75) which requires that every certificate of incorporation shall contain either one of the following statements:

"A. 'The capital of the corporation shall be at least equal to the sum of the aggregate par value of all issued shares having par value, plus ——— dollars (the blank space being filled in with some number representing one dollar or more) in respect to every issued share without par value, plus such amounts as, from time to time, by resolution of the board of directors, may be transferred thereto;' or

"B. 'The capital of the corporation shall be at least equal to the sum of the aggregate par value of all issued shares having par value, plus the aggregate amount of consideration received by the corporation for the issuance of shares without par value, plus such amounts as, from time to time, by resolution of the board of directors, may be transferred thereto."

This laid down a clear formula for determining what amount of assets originally paid in for stock was regarded by the law as "capital". Obviously it is only an arithmetical figure. If the corporation suffered losses, the figure remained the "capital" of the corporation on its books, though the assets did not then equal the capital; and the amount of the impairment of capital would show up as a "deficit" —just as if more assets were acquired by the corporation so that its assets were more than its "capital", the balance would appear as "surplus".

The last development again responded to the exigencies of businessmen. During the 1928–1929 bubble, they sought and got from the Delaware Legislature (the Delaware law being then most popular), a singular provision permitting issuance of no par stock by a corporation and the receipt of consideration therefor, but permitting the directors within 60 days after the issue of non-par stock to determine how much of the consideration should be set up as "capital" and how much as "surplus". In such case, a buyer of the stock during that period would not even know whether his subscription was to be part of the permanent investment of the business, or whether it might not promptly be distributed as dividends. But, before the expiration of the period, the corporation was required to file a certificate stating how the consideration for these shares had been set up, so that there was at length on the record in the Office of the Secretary of State of Delaware, and presumably also on the books of the corporation, the statement of the corporation that it had set aside a stated amount of the consideration required for the issued shares as "capital" which resolved the uncertainty.

CAPITAL SEGREGATED TO CLASSES OF STOCK

The arithmetical formula for determining legal capital of a corporation still did not meet the desires of certain businessmen. As will be seen in the cases, the law restricts the use of "capital" in two principal ways: dividends cannot be paid out of capital; and the corporation cannot buy back or retire its own stock out of capital. To do either of these things would be to diminish the amount of assets which in theory the corporation was to conserve to take care of creditors.

The business conflict arose with the development of preferred stock. The businessmen looked on preferred stock really as a credit instrument—a method of securing money (he would call it "capital" whereas as we have seen the legal rule may be different) in return for which the preferred shareholder got an agreement that in case the corporation were liquidated or wound up, his preferred share should be paid before the common stock up to a stated amount (say, $100) and would receive an annual fixed dividend—(say, 6% and no more) before the common stock got anything. The preferred stockholder was supposed to take less risk and a limited dividend in return for greater security.

The managements of corporations, however, liked the idea of being able to retire, or "redeem" preferred stock whenever it was advantageous to do so, just as they would pay off a note or a debt. Especially when it was possible to secure money at a lower rate than the preferred dividend, it was highly profitable to call in the preferred stock, paying the stated amount, and refinancing by issuing a new

preferred stock at a lower dividend rate. Consequently, preferred stock, besides being limited as to dividend, and limited as to the amount it would receive if the corporation should be wound up, was made "redeemable" on call by the corporation at a fixed amount—commonly with a slight premium over the amount originally paid for it. But at this point the management ran into the classic conception that stock could not be bought back or retired or redeemed out of "capital", since this was supposed to be held intact for creditors. By consequence, in certain states, notably Delaware, statutory privilege was granted, when preferred stock was redeemed or retired, to deduct the amount used for redemption from capital, and not from surplus. This was handy: the amount of capital (determined by the statutory formula) was reduced; the surplus was undiminished and could be used to pay dividends and so forth.

Where preferred stock had a par value, and was thus retired, the formula was simple: the aggregate par value of the preferred stock so redeemed could easily be taken and subtracted from the previous legal capital.

But, when the preferred stock had not a par value, and especially when the preferred stock had been issued and the price paid to the corporation had been declared by the corporation to be partly capital and the rest surplus, matters became complicated. For the management naturally wanted to deduct from its legal capital, not the amount that the statute or the certificate of incorporation had made it set up as capital when the stock was issued, but rather the amount it paid out to retire the stock. Thus a share of non-par preferred might have been issued originally for $100, of which $50 was required to be set up as capital and the remaining $50 as paid in surplus; the share to be redeemable at $100. When it redeemed the share, the management would like, if it could, to deduct the full $100 from its capital account, leaving its surplus intact. But only $50 per share had been set up as legal capital; and if the corporation were permitted to deduct $100 per share on redemption, the result might be that the redemption would wipe out the entire capital account. So the Delaware law permitted the corporation only to deduct from the capital account, on redemption of any class of stock, the amount of capital "represented by" the shares of stock so redeemed. The statutory phrase was unhappy and vague.

The law had always permitted a corporation to transfer from surplus to capital additional amounts if the corporation so desired. The new practice suggested, and the new Delaware law provided, that such transfers could be made from surplus to capital and "allocated" to a particular class of stock. Thus, in our supposed case of an issue put out at $100, of which $50 was set up as the capital and $50 as surplus, at some future time the directors might decide to transfer from surplus to capital a sum equal to $50 per share of that particular class of stock and "allocate" the transfer to that class. Then, of course, they could redeem or retire the stock and write off the entire amount for capital. The precise implications of this new development—capital which is or can be "allocated" to particular classes of stock, have yet to be fully worked out. Before this development, legal capital had merely been (and indeed still usually is) merely a figure worked out by a formula. The balance sheet must show assets equal to the amount of all outstanding debts, plus the legal capital, if the corporation is to be able to declare dividends, or buy back its stock. When the assets are not equal to the total of its debts, plus its "capital", the capital of the corporation is said to be "impaired" by the amount of the deficit.

SURPLUS

Surplus may be defined as the excess of assets of a corporation over the sum of its outstanding debts, plus its legal capital.

Correspondingly, a "deficit" occurs when the sum of the assets adds up to less than the sum of the debts, plus legal capital.

Surplus may arise in several ways.

(1) *Earned surplus.* These are profits arising from the operation of the business, not yet distributed to the shareholders. Clearly if a corporation goes into business, and makes money, at the end of a period of time its assets will have been increased. After deducting the amount of debts, and the legal capital, there will be a balance over arising from operations. This is "earned surplus".

(2) *Capital surplus.*

(a) *Paid in surplus.* As we have seen above, a corporation when it issues its shares may exact a price greater than the amount required to be set up as "capital". It may, for example, sell a share having $100 par value for $150, the additional $50 being "paid in surplus"; or it may sell a no par share under an arrangement like the New York option A when the charter requires that, say, $5 in respect of each no par share shall be set up as capital, and any balance over may be set up as "surplus". This also would be "paid in surplus". Under the extreme Delaware permission, a corporation might sell no par stock for $25 and within the statutory period file a certificate determining that $5 of this should be set up as capital and the balance as surplus—again, paid in surplus. The paid in surplus is in theory at least not subject to the restrictions surrounding capital, can be paid out as dividends, or used to buy in shares of the corporation's own stock;

(b) *Revaluation surplus.* A corporation may invest part of its assets—for example, one million dollars—in a plant. Later it may reappraise that plant, finding that the value doubled since the plant was acquired. Following this appraisal it would then raise the figure on its asset aside from one million to two million dollars. The additional million on the asset side would then show up as an additional balance of assets over debts and capital, thus increasing the surplus figure. The additional amount was not earned; and it was not paid in; but it arises from revaluation.

(c) *Non-recurring profit credited to surplus.* This is really a variation on revaluation surplus. A fixed asset may have been acquired for the business—say, for instance, a piece of land. Some years later, the corporation sells the land at a large profit. The land previously appeared as an asset on the corporation books at its cost; on sale, it disappears from the corporation's asset list and is represented instead by an amount of cash considerably larger. The excess is profit; but not profit derived from the operation of the corporation's business but rather in the nature of a windfall. Careful accountants regard this as "non-recurring income", do not let it appear in the statement of earnings, and credit it directly to the surplus account.

A careful accountant, today, when he deals with corporate surplus, distinguishes between the surplus that has been earned and the capital surplus. Commonly he will attach to the corporation's balance sheet a statement of surplus, or an analysis of the surplus account, showing not only what the surplus is, but where it came from.

There are other ways in which the surplus account may be swelled: For instance, retirement of debts by payment at less than face, or purchase and retirement by the corporation of its own stock for a price less than its par or capital amount.

1. CONCEPT OF CAPITAL AS REPRESENTED BY STOCK

NEW YORK STOCK CORPORATION LAW

§ 13. *Capital.* For the purpose of any rule of law or of any statutory provision relating to the amount of the capital of a stock corporation, the capital of any corporation authorized to issue shares without par value shall be deemed to be an amount computed in

accordance with the statements respecting its capital contained in its certificate of incorporation or other certificate filed pursuant to law, or in a special law creating the corporation; and the capital of any corporation not authorized to issue shares without nominal or par value shall be deemed to be the aggregate par value of its issued shares plus such amounts as, from time to time, may be transferred to capital by resolution of the board of directors.

DELAWARE GENERAL CORPORATION LAW

§ 14. * * * Any corporation may by resolution of its Board of Directors determine that only a part of the consideration which shall be received by the corporation for any of the shares of its capital stock which it shall issue from time to time shall be capital; provided, however, that, in case any of the shares issued shall be shares having a par value, the amount of the part of such consideration so determined to be capital shall be in excess of the aggregate par value of the shares issued for such consideration having a par value, unless all the shares issued shall be shares having a par value, in which case the amount of the part of such consideration so determined to be capital need be only equal to the aggregate par value of such shares. In each such case the Board of Directors shall specify in dollars the part of such consideration which shall be capital. If the Board of Directors shall not have determined (a) at the time of issue of any shares of the capital stock of the corporation issued for cash or (b) within sixty days after the issue of any shares of the capital stock of the corporation issued for property other than cash what part of the consideration for such shares shall be capital, the capital of the corporation in respect of such shares shall be an amount equal to the aggregate par value of such shares having a par value, plus the amount of the consideration for such shares without par value. The capital of the corporation may be increased from time to time by resolution of the Board of Directors directing that a portion of the net assets of the corporation in excess of the amount so determined to be capital be transferred to capital account. The Board of Directors may direct that the portion of the excess net assets so transferred shall be treated as capital in respect of any shares of the corporation of any designated class or classes. The excess, if any, at any given time, of the total net assets of the corporation over the amount so determined to be capital shall be surplus.

In any case in which the law requires that the par value of the shares of the capital stock of a corporation be stated in any certificate or paper, it shall be stated in respect of any shares without par value that such shares are without par value and wherever the amount of the authorized or issued capital stock of the corporation is required to be stated and the corporation shall have any shares without par value, it shall be sufficient to state the total number of shares authorized or issued, as the case may be, the number and par value of shares having a par value and the number of shares without par value.

WILLIAMS v. WESTERN UNION TELEGRAPH CO.

Court of Appeals of New York, 1883. 93 N.Y. 162.

Appeal by defendant from an order of General Term of the Superior Court of the city of New York, reversing a judgment for defendant and granting a new trial.

[The directors of defendant company had entered into an agreement to take over the properties, privileges, and franchises of the Atlantic and Pacific Telegraph Co. and of the American Union Telegraph Co. in exchange for stock of defendant company. In order to carry out the agreement, defendant planned to increase its capital stock from $38,926,590 to $80,000,000. $23,400,000 was to be used to acquire the assets of the two corporations and $15,526,580 was to be paid out in stock dividends to defendant's shareholders.

The consolidation plan was approved by a three-quarters vote of defendant's shareholders at a special meeting. Plaintiff, a shareholder, voted against the plan.

Plaintiff brought suit in equity against the corporation and its directors to enjoin the issuance and delivery of any certificates of stock except for cash, and to restrain the company from transferring on its books any of such increased capital stock beyond its authorized capital. Plaintiff alleged: (1) the proposed consolidation was an unlawful conspiracy; (2) the prices agreed upon for the purchase were a fraud upon plaintiff and other shareholders; (3) defendant did not have surplus property over and above its capital stock sufficient to represent the stock dividend, and hence the declaration of the dividend was a violation of N.Y.Rev.Stat., 1829, c. 18, § 2.[1]

The trial court found: (1) the agreement was a legitimate purchase and consolidation; (2) the stock dividend was not in violation of the statute; (3) the agreements were so far under way that no shareholder had any right to seek to restrain their completion; (4) plaintiff neither had nor would suffer any injury from the execution of the plan; judgment for defendant. Plaintiff appealed; General Term condemned the dividend as a violation of the statute and reversed the trial court. Defendant company alone appeals.]

EARL, J. * * * A careful reading of the section shows that it has reference only to the property of a corporation and not to its share capital. The first clause prohibits dividends of property except from surplus profits. It is further provided that the directors of any corporation shall not divide, withdraw or in any way pay to the stockholders, or any of them, any part of the capital stock of such company, or to reduce the capital stock without the consent of the leg-

[1] "It shall not be lawful for the directors or managers of any incorporated company in this State to make dividends excepting from the surplus profits arising from the business of such corporation; and it shall not be lawful for the directors of any such company to divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the capital stock of such company, or to reduce the said capital stock without the consent of the legislature * * *"

Cf. N. Y. Stock Corporation Law, § 58, infra, p. 384.

islature. These provisions were intended to prevent the division, distribution, withdrawal and reduction of the property of a corporation below the sum limited in its charter or articles of association for its capital, but not to prevent its increase above that sum. The purpose was to prevent the depletion of the property of the corporation thereby endangering its solvency. All the other provisions of the section show very clearly that such was the intention. Careful provision was made that the whole amount of capital stock should be paid in, and hence there was a prohibition against receiving a note or other evidence of debt in payment of any installment actually called in and required to be paid; and in case the directors violated any of the provisions of the section they were made individually liable to the corporation and to its creditors, in the event of its dissolution, to the full amount of the capital stock of the company so divided, withdrawn or reduced. All these provisions show that it was the purpose of the legislature, by means of them, to create a property capital for the corporation, and then to keep that intact so as to secure the solvency of the corporation and its responsibility to its creditors. The "capital stock" in this section does not mean share stock, but it means the property of the corporation contributed by its stockholders or otherwise obtained by it, to the extent required by its charter. While the term "capital stock" is frequently used in a loose and indefinite sense, in this section and in legal phrase generally it means that and no more. In State v. Morristown Fire Association, 3 Zabr., 23 N.J.Law, 195, Green, Ch. J., said: "The phrase 'capital stock' is very generally, if not universally, used to designate the amount of capital to be contributed for the purposes of the corporation. The amount thus contributed constitutes the 'capital stock' of the company." In Burrall v. Bushwick R. R. Co., 75 N.Y. 211, Folger, J., defined "capital stock" as "that money or property which is put in a single corporate fund by those who by subscription therefor become members of a corporate body." In Barry v. Merchants' Exchange Co., 1 Sandf.Ch. 280, Vice-Chancellor Sanford said: "The capital stock of a corporation is like that of a copartnership or joint-stock company, the amount which the partners or associates put in as their stake in the concern." By loss or misfortune, or misconduct of the managing officers of a corporation, its capital stock may be reduced below the amount limited by its charter; but whatever property it has up to that limit must be regarded as its capital stock. When its property exceeds that limit, then the excess is surplus. Such surplus belongs to the corporation and is a portion of its property, and, in a general sense, may be regarded as a portion of its capital, but in a strictly legal sense it is not a portion of its capital, and is always regarded as surplus profits. The very section we are considering contemplates that there may be a surplus, and that such surplus may be divided. The surplus may be in cash, and then it may be divided in cash; it may be in property, and if the property is so situated that a division thereof among the stockholders is practicable, a dividend in property may be declared, and that may be distributed among stockholders. All such dividends

diminish and deplete the property of the corporation, and that section was designed to prevent dividends of property which tended to deplete the assets of the company below the sum limited in its charter as the amount of its capital stock. * * *

Order of General Term reversed, and judgment accordingly.[2]

PEOPLE ex rel. UNION TRUST CO. v. COLEMAN.

Court of Appeals of New York, 1891. 126 N.Y. 433, 27 N.E. 818, 12 L.R.A. 762.

Appeal from a judgment of General Term entered on an order affirming an order of Special Term dismissing a writ of certiorari to review an assessment of the relator's capital for the year 1889.

[Plaintiff is a trust company in New York. It furnished a statement of its assets and liabilities to the tax commissioner and claimed that since all its capital stock and surplus was invested in United States securities, it was tax exempt. The commissioners held that the capital stock, the actual value of which they were to assess pursuant to statute,[3] was the shares, and they ascertained such value by multiplying the nominal capital by the market price of the shares and deducted therefrom 10% of the nominal capital, the assessed value of the real estate, and the investments in United States securities.]

FINCH, J. The relator has been assessed upon an "actual value" of its capital stock derived entirely from the market value of its shares. These are selling at the large premium of something over $500 for each share of $100, and the assessors have concededly taken that valuation, or the principal part thereof, as the "actual value" of the company's stock liable to taxation, instead of its own proved and established value. The relator challenges the assessment, and through all the proceeding has persistently raised and pressed the inquiry, not so much as to the mode or manner of ascertaining value, but, rather, as to what is the precise thing to be valued,—whether the capital stock of the company, or the capital stock held in shares by the corporators. If these are the same, or, in any just sense, equivalents, either might be valued without substantial error; but, if they are not such, we must determine which is to be valued before we can solve the problem of how to value it.

Now, it is certain that the two things are neither identical nor equivalents. The capital stock of a company is one thing; that of the shareholders is another and a different thing. That of the com-

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[2] That part of the opinion dealing more fully with stock dividends appears infra, p. 443.

[3] N.Y.Laws 1857, c. 456, § 3: "The capital stock of every company liable to taxation, except such part of it as shall have been exempted by law, together with its surplus profits or reserved funds exceeding 10% of its capital, after deducting the assessed value of its real estate, and all shares of stock in other corporations actually owned by such company which are taxable upon their capital stock under the laws of this state shall be assessed at its actual value and taxed in the same manner as the other real and personal estate of the county."

pany is simply its capital, existing in money or property or both; while that of the shareholders is representative, not merely of that existing and tangible capital but also of surplus, of dividend earning power, of franchise, and the goodwill of an established and prosperous business. The capital stock of the company is owned and held by the company in its corporate character; the capital stock of the shareholders they own and hold in different proportions as individuals. The one belongs to the corporation; the other, to the corporators. The franchise of the company, which may be deemed its business opportunity and capacity, is the property of the corporation, but constitutes no part or element of its capital stock; while the same franchise does enter into and form part, and a very essential part, of the shareholder's capital stock. While the nominal or par value of the capital stock and of the share stock are the same, the actual value is often widely different. The capital stock of the company may be wholly in cash or in property, or both, which may be counted and valued. It may have in addition a surplus, consisting of some accumulated and reserved fund, or of undivided profits, or both; but that surplus is no part of the company's capital stock, and therefore is not itself capital stock. The capital cannot be divided and distributed; the surplus may be. But that surplus does enter into and form part of the share stock, for that represents and absorbs into its own value surplus as well as capital, and the franchise in addition; so that the property of every company may consist of three separate and distinct things, which are its capital stock, its surplus, and its franchise; but these three things, several in the ownership of the company, are united in the ownership of the shareholders. The share stock covers, embraces, represents all three in their totality; for it is a business photograph of all the corporate possessions and possibilities. A company also may have no surplus, but, on the contrary, a deficiency which works an impairment of its capital stock. Its actual value is then less than its nominal or par value, while yet the share stock, strengthened by hope of the future and the support of earnings, may be worth its par, or even more. And thus the two things, the company's capital stock and the shareholder's capital stock, are essentially and in every material respect different. They differ in their character, in their elements, in their ownership, and in their values. How important and vital the difference is became evident in the effort by the state authorities to tax the property of the national banks. The effort failed, and yet the share stock in the ownership of individuals was held to be taxable as against them. The corporation and its property were shielded, but the shareholders and their property were taxed. * * *

There are reasons in abundance for the conclusion that by the phrase "capital stock" the statute means not the share stock, but the capital owned by the corporation; the fund required to be paid in and kept intact as the basis of the business enterprise, and the chief factor in its safety. * * *

Judgment reversed and assessment vacated and canceled.

NOTES

(A) "Note the distinction between capital stock in a corporation and the capital of that corporation, the latter being the entire amount of property owned by the corporation. A corporation's capital consists of that portion of its property which represents capital stock plus whatever surplus it may have at the time. The difference between the two is real, being one of kind and not in amount. Capital is tangible. Capital stock is a mental conception * * * Capital may and usually does, change constantly. Capital stock remains the same unless and until the charter of the corporation is amended and its capitalization changed. Capital stock when issued becomes the property of the shareholders. Capital remains the property of the corporation for as long a time as the corporation itself remains in existence * * *" Pomeroy, Capital Stock, 1938, 2 Peabody L.Rev. 77. See, also, 11 Fletcher, Cyclopedia of the Law of Private Corporations, Rev. and Perm. Ed.1932, §§ 5083, 5084; Dwight, Capital and Capital Stock, 1907, 16 Yale L.J. 161; Note, 1936, 35 Mich.L.Rev. 283.

(B) "A share of stock is generally defined as a chose in action entitling the holder to participate in the net profits earned by the corporation, and on dissolution of the corporation, to a proportion of the property of the corporation remaining after the payment of debts." 1923, 23 Col.L.Rev. 303.

EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES v. UNION PACIFIC RAILROAD CO.

Court of Appeals of New York, 1914.
212 N.Y. 360, 106 N.E. 92, L.R.A.1915D, 1052.

Appeal, by permission, from an order of the Appellate Division of the Supreme Court in the first judicial department, entered May 1, 1914, which affirmed an order of Special Term granting a motion by defendant for judgment in its favor upon the pleadings.

The following question was certified: "Does the complaint state facts sufficient to constitute a cause of action?"

HISCOCK, J. This action was brought by the plaintiff as the holder of a large amount of the preferred stock issued by defendant to restrain the distribution by the latter of about $80,000,000 as a dividend among its common stockholders. The material facts set forth in the complaint which asks this relief are as follows:

At the times involved the defendant had a large outstanding issue both of preferred and common stock. Prior to January 8, 1914, it had carried to the credit of its profit and loss account large amounts based on valuations which are not questioned, and at that date the credit balance of this account was more than $80,000,000. Of this amount upwards of $15,000,000 had accrued through the retirement of defendant's convertible bonds with common stock on a basis of one share of stock at par for $175 par value of bonds, and upwards of $58,000,000 had accrued as gain or profit on the sale of stocks of other corporations purchased and held by or for the benefit of the defendant. On the date above mentioned the defendant declared the extraordinary dividend in issue payable in cash and property to its common stockholders and chargeable against said balance so stand-

ing to the credit of its profit and loss account. The plaintiff holds its preferred stock under a clause in the defendant's articles of association which reads as follows:

"Such preferred stock shall be entitled, in preference and priority over the common stock of said corporation, to dividends in each and every fiscal year, at such rate, not exceeding four per cent. per annum, payable out of net profits, as shall be declared by the Board of Directors. Such dividends are to be non-cumulative, and the preferred stock is entitled to no other or further share of the profits."

It is conceded that the plaintiff has received all of the dividends and "profits" to which it is entitled under the foregoing article. It is also conceded that the amount carried to the credit of profit and loss as above stated need not be retained by the defendant but may be distributed among its stockholders. It is, however, insisted that this balance does not represent profits which under the foregoing article may be distributed exclusively amongst holders of common stock, but that it represents to the extent of the two items above mentioned an increase of or accretion to capital which must be distributed as capital amongst all the stockholders including those holding preferred stock. Thus arises the question which we are required to decide. If this is a distribution, even though unusual in amount, of accumulated gains or profits of a character which the directors of a going corporation may at any time in their discretion divide amongst the stockholders as returns or income on their investment, the plaintiff has no ground for complaint. It elected to take stock having a preferred but limited right to dividends and profits. It chose the right to returns on its investment which made up in certainty for what they lacked in possible quantity, and there is no inequity in holding it to its choice. If, on the other hand, all or part of the gains which it is proposed to distribute are accretions to and have somehow become permanent capital and been withdrawn from availability for dividends it will be assumed that they must be distributed amongst all the stockholders.

When a corporation is organized it secures capital by the issue of shares of capital stock. The fund or property thus secured answers the twofold purpose of furnishing means for carrying on the operations of the corporation and also security for the payment of creditors. This capital stock is carried as a liability and universally, so far as I am aware, at its par amount. It is thus carried as a liability because this is the proper bookkeeping entry. But aside from this, such entry also serves to emphasize the duty of the corporation to keep its capital stock unimpaired for the protection of those dealing with it. If the operations of the corporation result in gains, such gains are carried to the credit, not of the capital stock account but of some other account as surplus or profit and loss. Of course they may be capitalized by the issue of stock against them and sometimes in the cases of certain corporations like banks or insurance corporations where a certain ratio between assets and liabilities other than to capital stock is required, such surplus or profits may be counted and maintained as capital although not formally capitalized.

In the absence of some such special consideration I think we may take notice that it is the ordinary rule of corporate management established by decisions, statutes and business usages that the surplus of these gains or profits beyond what may be necessary to keep good the liability to capital stock which has been issued, may, in the discretion of a board of directors, be distributed amongst its stockholders as dividends and returns on their investment. Such being the general rule, it is incumbent on the plaintiff to show that there is something so peculiar in the two transactions being considered that the profits resulting therefrom are of a different nature in respect of this subject than those ordinarily realized in corporate business, and I think it has failed to do this.

I shall not attempt to discuss whether there might be an accretion to or increment of capital of a going corporation under such circumstances and of such a character that it would become permanent capital and might not be distributed as dividends. That question for the purposes now concerning us doubtless would be surrounded with some uncertainty and difficulties. It is sufficient for this appeal to consider the transactions before us and see, as I think we must, that there is nothing about them which impresses their results with any other character than that of ordinary current profits which the directors may in their discretion divide among the stockholders entitled to dividends.

It is said, because in the retirement of its convertible bonds defendant sold and issued its capital stock at \$175 per share of \$100 par value, that this entire sum was paid in as capital and must be held and distributed as such. That is not my interpretation of the transaction under the allegations of the complaint. The amount at par value paid for each share of stock undoubtedly became capital which the corporation was required to preserve and maintain as against its liability on the outstanding share of stock which had been issued for it. Just as undoubtedly the extra \$75 paid per share represented the amount of accumulated profits or surplus which it was supposed would be apportionable to each share of new stock after payment and issue as aforesaid. In other words, as I think we must assume, the payment of this premium was not for permanent capital but for the purpose of equalizing as between new and old stockholders their respective rights in accumulated profits which so far as we know were current and distributable in dividends. When paid in this premium became part of such accumulation of profits and surplus and distributable as such. It was credited to profit and loss and not to capital.

It is unnecessary to decide what would be the rule of distribution in the case stated by plaintiff by way of illustration where stockholders on the organization of a bank subscribe for stock at double its par value for the express purpose of creating a permanent surplus or capital with the intent of affording a greater security to creditors and attracting depositors. That case is utterly different from this one.

The other transaction which produced a large item in the profit and loss account was the purchase and sale at an advance of various stocks. Ordinarily the profits made by a corporation on the purchase and sale of property would so clearly belong to a fund applicable to the payment of dividends that there would be no debate about it. The plaintiff in this case, however, says in substance that the defendant was not organized to deal in stocks and, therefore, the preferred shareholders could not have had such profits in mind when they agreed to take four per cent. dividends in full of their share of the profits and, therefore, further, "an accretion realized from such traffic is not profits within the contemplation of the instrument (defendant's charter), but belongs to capital." It seems to me that this reasoning involves a misinterpretation of the charter and a decided non sequitur. The language by which these stockholders relinquished all other claims to profits in consideration of preferential dividends was broad and comprehensive. They were to be "entitled to no other or further share of the profits." There is no limitation on this exclusion from any farther participation in whatever was profits, nothing to suggest that one item of profits was to be differentiated from another by the nature of the transaction which produced it. The contract was that whatever in the way of profits went into the profit and loss account should be subject to a payment of certain dividends on preferred stock before common stock received any and that was the end of the rights of the former class of stock so far as profits were concerned. The result of the transaction in question was a profit and the distribution of it is subject to this agreement. This seems so clear that it is difficult by discussion to make it more so. The proposition that these profits because resulting from what was perhaps an unusual transaction are not profits, but are an accretion which "belongs to capital," notwithstanding the painstaking argument of counsel, does not seem to have any foundation on which to rest except earnest assertion. * * *

As against the contentions of the plaintiff, I think it is abundantly established by decisions which are in conformity with and fortified by commercial understanding and experience that the gains or profits realized by a corporation at least from its active transactions such as those under consideration here constitute profits and surplus which are available for dividends. Williams v. Western Union Tel. Co., 93 N.Y. 162, 191; Lubbock v. British Bank of So. Amer., L.R. [1892] 2 Ch.Div. 198; Mackintosh v. Flint & P. M. R. Co., C.C., 34 F. 582, 606. * * *

The order appealed from should be affirmed, with costs, and the question certified to us answered in the negative.

WERNER, COLLIN, HOGAN, MILLER and CARDOZO, JJ., concur; WILLARD BARTLETT, Ch. J., not sitting.

Order affirmed.[5]

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[5] Reiter, Profits, Dividends and the Law, 1926, 221–222, 228–229; Note, 1914, 14 Col.L.Rev. 524; 1914, 14 Col.L.Rev. 534, 601; 1914, 27 Harv.L.Rev. 758.

The Supreme Court decision is commented upon, 1914, 27 Harv.L.Rev. 758.

B. STOCK

STOKES v. CONTINENTAL TRUST COMPANY OF CITY OF NEW YORK.[1]

Court of Appeals of New York, 1906. 186 N.Y. 285, 78 N.E. 1090.

VANN, J. * * * What is the nature of the right acquired by a stockholder through the ownership of shares of stock? What rights can he assert against the will of a majority of the stockholders, and all the officers and directors? While he does not own and cannot dispose of any specific property of the corporation, yet he and his associates own the corporation itself, its charter, franchises, and all rights conferred thereby, including the right to increase the stock. He has an inherent right to his proportionate share of any dividend declared, or of any surplus arising upon dissolution, and he can prevent waste or misappropriation of the property of the corporation by those in control. Finally, he has the right to vote for directors and upon all propositions subject by law to the control of the stockholders, and this is his supreme right and main protection. Stockholders have no direct voice in transacting the corporate business, but through their right to vote they can select those to whom the law intrusts the power of management and control.

A corporation is somewhat like a partnership, if one were possible, conducted wholly by agents where the copartners have power to appoint the agents, but are not responsible for their acts. The power to manage its affairs resides in the directors, who are its agents, but the power to elect directors resides in the stockholders. This right to vote for directors, and upon propositions to increase the stock or mortgage the assets, is about all the power the stockholder has. So long as the management is honest, within the corporate powers, and involves no waste, the stockholders cannot interfere, even if the administration is feeble and unsatisfactory, but must correct such evils through their power to elect other directors. Hence, the power of the individual stockholder to vote in proportion to the number of his shares is vital, and cannot be cut off or curtailed by the action of all the other stockholders, even with the co-operation of the directors and officers. * * *

1. CREATION

TRIPLEX SHOE COMPANY et al. v. RICE & HUTCHINS, Incorporated, et al.

Supreme Court of Delaware, 1930. 17 Del.Ch. 356, 152 A. 342.

Application by Rice & Hutchins, Incorporated, for the determination of election of directors of the Triplex Shoe Company, opposed by

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1 Statement of facts and remainder of opinion appears, infra, p. 339.

the Triplex Shoe Company and others. Decree for petitioner (147 A. 317), and respondents appeal.

Affirmed.

PENNEWILL, C. J. This case is an appeal from the decision, 147 A. 317, of the Chancellor determining, under the provisions of section 31 of the General Corporation Law of the State (Rev.Code 1915, § 1945, as amended by 35 Del.Laws, c. 85, § 15), who were elected directors of the Triplex Shoe Company at the last annual meeting of the stockholders thereof held January 28th, 1929. The proceeding below was on a stockholder's petition asking for the determination by the Chancellor of the validity or invalidity of such election. * * *

Notwithstanding the voluminous briefs filed in the case, and the elaborate arguments and numerous contentions made by counsel, the Court think the case, so far as the real issues are concerned, lies within a narrow compass. The important question is, was there any common stock voted for the "B" ticket at the election in 1929 that was legally issued and outstanding at that time? It is admitted by the appellees that if there was any such stock the preferred stock could not be voted because the sole voting power resided in the holders of the common stock, and the "B" ticket was, therefore, properly declared elected.

It is admitted by the appellants that the preferred par value stock was valid stock and outstanding at the time of the election, but denied that it was entitled to vote for a reason considered in the Court's opinion.

The Chancellor decided that there was no valid common stock outstanding at the time of the election that had a right to vote, and that the preferred stock was legally voted.

To determine the correctness of the Chancellor's decision three questions must be considered, viz.:

1. Was there any common stock legally issued by the corporation under its original certificate of incorporation? * * *

The original certificate provided that

"Fourth: The amount of the total authorized capital stock of this corporation is One Hundred and Fifty Thousand Dollars ($150,000.00) divided into seven hundred and fifty preferred shares of the par value of One Hundred Dollars ($100.00) each. And the remaining seventy-five thousand dollars in shares of common stock without any par value.

"The amount of capital stock with which this corporation will commence business is five thousand dollars ($5,000.00)."

It will be observed that in the original certificate of incorporation two classes of stock were created, a preferred with par value, and a common with no par value. The preferred, however, was such only in name, no preference being stated, as required by law.

It is claimed by the appellee that the language in the charter providing that the remaining $75,000 (of capital) in shares of common stock without par value, is inoperative as a grant of authority for the issue of such shares, in that it is in direct violation of section 5 of paragraph 4 of the Delaware Corporation Law (Rev.Code 1915, § 1919, par. 4, as amended by 35 Del.Laws, c. 85, § 4), which provides that with re-

spect to no par value stock, the certificate shall state the total number of shares authorized, that they are without nominal or par value, and the number of shares with which it will commence business, which shall not be less than ten shares.

This was the law at the time the original certificate of incorporation was granted and we can see no answer to the contention that the language of the certificate respecting the shares of common stock without par value was unauthorized by law, and therefore, inoperative. Certainly no authority or argument is needed to support the proposition that the authority of a corporation to issue stock is fixed by the law of the State which grants the authority, and neither the incorporators or any other officers can change, modify or supplement the law in that regard. The provision, therefore, in the certificate of incorporation that a certain part of the capital of the incorporation is in shares of common stock without any par value, without stating the number of shares is not only unauthorized by any law of the State, and inoperative, but it is also meaningless in view of the law.

Such being the case, we can see no escape from holding that the no par value stock attempted to be issued under the original certificate of incorporation was invalid stock.

Manifestly the appellants appreciate the difficulty of maintaining the validity of such stock issue and seek to show that even if it was illegally issued, it had a right to vote because it was de facto stock.

As to this point we think that if there is such stock as de facto stock, recognized by the law in any case, there could not be and has not been, in a case where the charter provision respecting the issuance of no par stock was wholly unauthorized by the law of the State which granted the charter, and where there has not been a compliance with the law under which the corporation was organized. If there was no authority at all for the issuance of the stock, certainly its purported or attempted issue could not impress upon it the character of any kind of stock that the law would recognize. It may be that appellants think there can be de facto stock because the law recognizes, under some circumstances, de facto corporations. But being clear that there was no de facto stock in the present case it would be unprofitable to state at length the reasons for the recognition of de facto corporations, and the persons who can invoke the doctrine. The principle underlying the rule is largely one of estoppel. * * *

The cases relied on by appellants to show the curative effect of an amendment to a charter are distinguishable, we think, either on the ground that in such cases the corporation had the power to issue the kind of stock that was issued, or on the ground of estoppel.

The following authorities cited by appellants hold that an unauthorized over-issue may afterwards be rendered valid by a duly authorized increase. 14 C.J. 404; Thompson on Corp. 3561; Cook on Corporations 292; In re New Zealand Banking Corp., L.R. 3 Ch. 131, and Murphy v. Braker, 89 Hun. 387, 35 N.Y.S. 387.

But in the present case the corporation had no power to issue the kind of stock that was attempted to be issued; the act was void and not merely voidable, and under practically all the authorities, it is in-

capable of being cured or validated by an attempted ratification by amendment or other subsequent proceeding. * * *

The certificate of incorporation did not confer upon the Board of Directors authority to fix the consideration for no par value stock, and, therefore, the consideration could be fixed only by the stockholders as provided by the statute. The stockholders never fixed the consideration for any of the no par value stock issued by the corporation after its organization, and there is no escape from the conclusion that all such stock was invalid at the time of the election in question and not entitled to be voted. * * *

The decree of the Chancellor will be affirmed.

(a) Authorization

NEW YORK STOCK CORPORATION LAW

§ 11. *Preferred and common shares.* Every stock corporation shall have power to create and issue shares of stock. Every such corporation shall have power to create and issue two or more classes of shares, with such designations, preferences, privileges and voting powers or restrictions or qualifications thereof as the certificate of incorporation, or other certificate creating such shares and filed pursuant to law, provides; but no shares which are entitled to preference in the distribution of dividends or assets shall be designated as common stock or shares.

If any class of stock is preferred as to dividends or assets, the certificate of incorporation, or other certificate filed pursuant to law, may authorize the issuance from time to time in one or more series of the shares of any such class, and may authorize the board of directors to fix from time to time before issuance the designations, preferences, privileges and voting powers of the shares of each series of such class, and the restrictions or qualifications thereof; provided that the shares of all series of the same class having voting power shall not have more than one vote each, and when the stated dividends and amounts payable on liquidation are not paid in full, the shares of all series of the same class shall share ratably in the payment of dividends including accumulations, if any, in accordance with the sums which would be payable on said shares if all dividends were declared and paid in full, and in any distribution of assets other than by way of dividends in accordance with the sums which would be payable on such distribution if all sums payable were discharged in full.

Before the issuance of the shares of each series of such class, unless stated in respect to the first series in the certificate of incorporation or other certificate filed pursuant to law, and in that case before the issuance of each subsequent series, the corporation shall file a certificate entitled and endorsed "Certificate of (name of corporation) pursuant to section eleven of the stock corporation law," stating:

1. The name of the corporation, and, if it has been changed, the name under which it was originally incorporated;

2. The date of filing the certificate of incorporation in each state office where filed, or, if the corporation is created by a special law and has no certificate of incorporation, the chapter number and year of passage of such law;

3. The designations, preferences, privileges and voting powers of the shares of such series, and the restrictions or qualifications thereof. * * *

DELAWARE GENERAL CORPORATION LAW

Sec. 13. *Classes of Stock; Certificates Filed and Recorded in Certain Cases:*—Every corporation shall have power to issue one or more classes of stock or one or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value, with such voting powers, full or limited, or without voting powers and in such series and with such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the Certificate of Incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the Board of Directors pursuant to authority expressly vested in it by the provisions of the Certificate of Incorporation or of any amendment thereto. The power to increase or decrease or otherwise adjust the capital stock as in this Chapter elsewhere provided shall apply to all or any such classes of stock. Any preferred or special stock may be made subject to redemption at such time or times and at such price or prices and may be issued in such series, with such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof as shall be stated and expressed in the Certificate of Incorporation, or any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the Board of Directors as hereinabove provided. The holders of preferred or special stock of any class or of any series thereof shall be entitled to receive dividends at such rates, on such conditions and at such times as shall be stated and expressed in the Certificate of Incorporation, or in any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the Board of Directors as hereinabove provided, payable in preference to, or in such relation to, the dividends payable on any other class or classes of stock, and cumulative or non-cumulative as shall be so stated and expressed. When dividends upon the preferred and special stocks, if any, to the extent of the preference to which such stocks are entitled, shall have been paid or declared and set apart for payment, a dividend on the remaining class or classes of stock may then be paid out of the remaining assets of the corporation available for dividends as elsewhere in this Chapter provided. The holders of the preferred or special stock of any class or of any series thereof shall be entitled to such rights upon the dissolution of, or upon any

distribution of the assets of, the corporation as shall be stated and expressed in the Certificate of Incorporation, or any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the Board of Directors as hereinabove provided; and any preferred or special stock of any class or of any series thereof may be made convertible into, or exchangeable for, shares of any other class or classes or of any other series of the same or any other class or classes of stock of the corporation at such price or prices or at such rates of exchange and with such adjustments as shall be stated and expressed or provided for in the Certificate of Incorporation, or in any amendment thereto, or in the resolution or resolutions providing for the issue of such stocks adopted by the Board of Directors as hereinabove provided. * * * Before any corporation shall issue any shares of stock of any class or of any series of any class of which the voting powers, designations, preferences and relative, participating, optional or other rights, if any, or the qualifications, limitations or restrictions thereof, if any, shall not have been set forth in the Certificate of Incorporation or in any amendment thereto but shall be provided for in a resolution or resolutions adopted by the Board of Directors pursuant to authority expressly vested in it by the provisions of the Certificate of Incorporation or an amendment thereto, a certificate setting forth a copy of such resolution or resolutions and the number of shares of stock of such class or series shall be made under the seal of the corporation * * * shall be filed and a copy thereof shall be recorded in the same manner as Certificates of Incorporation are required to be filed and recorded * * *. Unless otherwise provided in any such resolution or resolutions, the number of shares of stock of any such class or series so set forth in such resolution or resolutions may be increased or decreased (but not below the number of shares thereof then outstanding) by a certificate likewise made, signed, filed and recorded setting forth a statement that a specified increase or decrease therein had been authorized and directed by a resolution or resolutions likewise adopted by the Board of Directors; and in case the number of such shares shall be so decreased, the number of shares so specified in said certificate shall resume the status which they had prior to the adoption of the first resolution or resolutions.

CHICAGO CITY RY. CO. v. ALLERTON.

Supreme Court of the United States, 1873. 18 Wall. 233, 21 L.Ed. 902.

The appellant in this case is a corporation owning a street railroad in the city of Chicago. The directors of the company, without consulting or calling a meeting of the stockholders, resolved to increase the capital stock of the company from $1,250,000 to $1,500,000. To this the appellee, who is a stockholder, objected and filed the bill in this case, praying for an injunction to prevent the increase. His position is, that it cannot be lawfully made without the concurrence of the stockholders, and in support of this view he relies upon the recent Con-

stitution of Illinois adopted in July 1870, by the 13th section of the 11th article of which it is declared as follows:

"No railroad corporation shall issue any stock or bonds except for money, labor, or property actually received and applied to the purposes for which such corporation was created, and all stock dividends and other fictitious increase of the capital stock or indebtedness of any such corporation, shall be void. The capital stock of no railroad corporation shall be increased for any purpose, except upon giving sixty days' public notice in such manner as may be provided by law."

The complainant also relies on an act of the legislature of Illinois[2] passed March 26, 1872, to execute and carry out the above provision of the Constitution by which, amongst other things, it is enacted that no corporation shall change its name or place of business, increase or decrease its capital stock, or the number of its directors, or consolidate with other corporations, without a vote of two thirds of the stock at a stockholders' meeting.

The defendant in its answer relies upon its charter, which was granted February 14, 1859, the 3d and 4th sections of which are as follows:

"Sec. 3. The capital stock of said corporation shall be $100,000 and may be increased from time to time at the pleasure of said corporation."

"Sec. 4. All the corporate powers of said corporation shall be vested in and exercised by a board of directors and such officers and agents as said board shall appoint."

[It is claimed that the 3d section confers an unrestricted right to increase the capital stock at will, and that the 4th vests this power in the board of directors, and that the constitutional provision and act above referred to, if applied to this corporation, would impair the validity of the contract. It is further claimed, however, that they do not apply to railways operated by horse power. The court below decreed in favor of the complainant and the company appealed:]

MR. JUSTICE BRADLEY:—Without attempting to decide the constitutional question, or to give a construction to the act of the legislature, we are satisfied that the decree must be affirmed on the broad ground that a change so organic and fundamental as that of increasing the capital stock of a corporation beyond the limit fixed by the charter cannot be made by the directors alone, unless expressly authorized thereto. The general power to perform all corporate acts refers to the ordinary business transactions of the corporation, and does not extend to a reconstruction of the body itself, or to an enlargement of its capital stock. A corporation, like a partnership, is an association of natural persons who contribute a joint capital for a common purpose, and although the shares may be assigned to new individuals in perpetual succession, yet the number of shares and amount of capital cannot be increased except in the manner expressly authorized by the charter or articles of association.

Authority to increase the capital stock of a corporation may, undoubtedly, be conferred by a law passed subsequent to the charter; but such a law should regularly be accepted by the stockholders. Such

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2 *Cf.* Ill. Business Corporation Act 1933, §§ 52, 53.

assent might be inferred by subsequent acquiescence; but in some form or other it must be given to render the increase valid and binding on them. Changes in the purpose and object of an association, or in the extent of its constituency or membership, involving the amount of its capital stock, are necessarily fundamental in their character, and cannot, on general principles, be made without the express or implied consent of the members. The reason is obvious.

First, as it respects the purpose and object. This may be said to be the final cause of the association, for the sake of which it was brought into existence. To change this without the consent of the associates, would be to commit them to an enterprise which they never embraced, and would be manifestly unjust.

Second, as it respects the constituency, or capital and membership. This is the next most important and fundamental point in the constitution of a body corporate. To change it without the consent of the stockholders, would be to make them members of an association in which they never consented to become such. It would change the relative influence, control and profit of each member. If the directors alone could do it, they could always perpetuate their own power. Their agency does not extend to such an act unless so expressed in the charter, or subsequent enabling act; and such subsequent enabling act, as before said, would not bind the stockholders without their acceptance of it, or assent to it in some form. Even when the additional stock is distributed to each stockholder pro rata, it would often work injustice, because many of the stockholders might be unable to take their respective shares, and might thus lose their relative interest and influence in the corporate concerns.

These conclusions flow naturally from the character of such associations. Of course, the associates themselves may adopt or assent to a different rule. If the charter provides that the capital stock may be increased, or that a new business may be adopted by the corporation, this is undoubtedly an authority for the corporation (that is, the stockholders) to make such a change by a stockholders' vote, in the regular way. Perhaps a subsequent ratification or assent to a change already made, would be equally effective. It is unnecessary to decide that point at this time. But if it is desired to confer such a power on the directors, so as to make their acts binding and final it should be expressly conferred.

Where the stock expressly allowed by a charter has not been all subscribed, the power of the directors to receive subscriptions for the balance may stand on a different footing. Such an act, might, perhaps, be considered as merely getting in the capital already provided for the operations and necessities of the company and, therefore, as belonging to the orderly and proper administration of the company's affairs. Even in such case, however, prudent and fair directors would prefer to have the sanction of the stockholders to their acts. But that is not the present case, and need not be further considered.

Decree affirmed.

NOTES

(A) The charter of the Albany Iron Manufacturing Co. fixed its capital stock at $300,000 with power in the corporation to increase it to $1,000,000. The directors increased the capital stock; later they fixed and limited it to a lesser amount. The statute under which the company was incorporated provided that shareholders should be individually liable to corporate creditors until the whole amount of the capital stock of the company is paid in. Sutherland, a judgment creditor of the corporation, sued Olcott, a shareholder, to recover the amount due Sutherland. If there had been a legal increase of capital stock, Olcott would be liable to Sutherland under the statute because the full capital stock of the corporation was not paid in. *Held*: Judgment for plaintiff. The increase in the capital stock was proper since it was done according to the charter. However, the attempt later to reduce the capital stock was invalid; the charter gave a right to increase the capital stock only, and no right or power to reduce it. Sutherland v. Olcott, 95 N.Y. 93, 1884.

(B) On the problem of the rights and powers of directors and shareholders, see Commercial National Bank v. Weinhard, 192 U.S. 243, 24 S.Ct. 253, 48 L.Ed. 425, 1903.

SCOVILL v. THAYER.

Supreme Court of the United States, 1881. 105 U.S. 143, 26 L.Ed. 968.

Error to the Circuit Court of the United States for the District of Massachusetts.

On November 25, 1870, the Fort Scott Coal and Mining Company was organized as a corporate body, under the general laws of the State of Kansas, with a capital stock of $100,000.

According to the laws[3] of that State, any corporation might increase its capital stock to any amount not exceeding double its authorized capital.

Under the provision of this law the Corporation, on April 19, 1871, increased its capital stock from $100,000 to $200,000. On October 16, 1872, the Corporation attempted, by taking the steps required by law for the lawful increase of stock, to increase its capital stock to $300,000, and on December 27, 1872, to make a further increase of $100,000. The nominal capital was thus raised to the sum of $400,000.

Nathaniel Thayer, the defendant in error, who was a holder of shares in the company, attended by proxy the meetings of the stockholders at which the third and fourth issues of stock were voted. After this attempted increase of the stock the officers and agents of the Company, by advertisements, bill-heads, and verbally, represented that its capital stock was $400,000.

Thayer was the holder of two hundred and eighty-five shares of the first two issues of stock. On two hundred of these shares he had paid to the Company $20 per share, and on the remaining eighty-five he had paid $40 per share. He was also the holder of five hundred and eighty-five shares of the third and fourth issues, upon which he had paid the Company $50 per share. No other payments were ever made by him on his shares of stock.

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[3] On the increase or reduction of capital stock, see N.Y.Stock Corporation Law, §§ 36–38, 45.

The other stockholders paid the same amounts on the shares of stock of the several issues held by them respectively. By agreement made at the date of the several issues of stock the amounts paid thereon were credited to the subscribers, and the balance unpaid credited by "discount", and certificates as for full paid shares were delivered to the subscribers, and the stock account between the Company and them balanced by such "discount".

On April 2, 1874 a petition in bankruptcy was filed against said Company in the United States District Court for the District of Kansas; on April 11, the Company was adjudicated a bankrupt; and on April 29, the plaintiffs in error were appointed its assignees. On March 31, 1876, the assignees filed their petition * * * for an order of the court directing them to make an assessment and call upon the unpaid stock of the Company for the purpose of paying its debts. * * * The court made an order that all the stockholders of the bankrupt Company show cause on April 21, 1876, why the assessment and call prayed for in said petition should not be made * * * R. S. Watson, a stockholder, * * * filed exceptions to the rule, on behalf of himself and all other stockholders * * * the court overruled the exceptions and decreed that the assessment and call be made upon the stock of the Company of seventy six per cent upon which should be credited to each stockholder any sums paid by him on his shares. * * *

On July 17, 1876, the assignees made an assessment and call upon the stockholders as authorized * * * but before the assessment could be collected, Watson, the stockholder before mentioned, filed a petition for the reversal of the order and decree of the district court. * * * (The decree of the district court was affirmed with slight modification.)

Thayer, the defendant in error, having failed to pay within the time limited by the court, the assessment made upon him on account of his unpaid stock, although served with notice to do so, the assignees, on April 9, 1877 brought against him in the Circuit Court of the United States for the District of Massachusetts, an action at law to recover the sum of $27,160, which was the amount of the assessment on his unpaid stock. * * * The court found for the defendant (on the ground of the statute of limitations. Plaintiffs appeal.)

MR. JUSTICE WOODS delivered the opinion of the court. * * * [4]

The defendant insists; first, that the third and fourth issues of stock, which were made after the limit had been reached, within which the amount of capital stock of the company was restricted by the laws of Kansas, were absolutely void, and no assessment could be made on them which he was bound to pay; secondly, that the sums voluntarily paid by him upon his void stock, should be applied to the payment of the balance due on his valid stock, and that when so applied they would fully satisfy the assessment thereon; and, thirdly, that in any event the facts sustained the plea of the Statute of Limitations. We shall consider these contentions in the order stated.

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[4] That part of the opinion dealing with shareholders' liability to corporate creditors, appears *infra*, p. 270.

The Constitution of Kansas[5] forbids special charters. Art. 12, sec. 1. All corporations in that State are, therefore, organized under general laws. The Fort Scott Coal and Mining Company was organized under the general law of the State, which, with its articles of incorporation, required by the law to be filed with the Secretary of State, constituted its charter. By the articles of incorporation the original stock of the company was fixed at $100,000. Chapter 23, section 14, of the Statutes of Kansas provides that "Any incorporation may increase its capital stock to any amount not exceeding double the amount of its authorized capital."[6] The second issue increased the stock of the Company to $200,000, which was the limit prescribed by its charter. The question, therefore, is whether the stock of the third and fourth issues, by which the aggregate amount was raised to $400,000 is or is not void.

As a general rule corporations can have and exercise only such powers as are expressly conferred on them by the Act of incorporation, and such implied powers as are necessary to enable them to perform their prescribed duties. Fertilizer Co. v. Hyde Park [97 U.S. 659, 24 L.Ed. 1036]; Salomons v. Laing, 12 Beav. 339; R. Co. v. Hawkes, 5 H.L.Cas. 341.

And it is well settled that a corporation has no implied power to change the amount of its capital as prescribed in its charter, and that all attempts to do so are void. President, etc., of Mechanics' Bank v. New York & N. H. R. R. Co., 13 N.Y. 599; New York & N. H. R. R. Co. v. Schuyler, 34 N.Y. 30; Chicago City R. Co. v. Allerton, 18 Wall. 233, 85 U.S., 21 L.Ed. 902; Stace & Worth's Case, L.R., 4 Ch.App., 682, note.

In this case the attempt to increase the stock of the company beyond the limit fixed by its charter was ultra vires. The stock itself was, therefore, void. It conferred on the holders no rights, and subjected them to no liabilities. If the stock of the first and second issues had been held by one set of holders and the stock of the third and fourth by another, in a contest between them the latter would have been excluded from all participation in the management of the company or in its profits. To decide that the holders of stock issued ultra vires have the same rights as the holders of authorized stock is to ignore and override the limitations and prohibitions of the charter. We think it follows, that if the holder of such spurious stock has none of the rights, he cannot be subjected to the liabilities of a holder of genuine stock. His contract to pay for spurious shares is without consideration, and cannot be enforced.

It is insisted, however, that the defendant in error having attended by proxy the meetings at which the increase of the stock of the company beyond the limit imposed by law was voted for, and having received certificates for the stock thus voted for, and after such increase

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[5] See N.Y.Const. art. X, § 1: "Corporations may be formed under general laws; but shall not be created by special act, except for municipal purposes, and in cases where, in the judgment of the legislature, the objects of the corporation cannot be attained under general laws. All general laws and special acts pursuant to this section may be altered from time to time or repealed."

[6] *Cf.* N.Y.Stock Corporation Law, § 36.

the company by its agents having held itself out as possessing a capital of $400,000, and invited and obtained credit on the faith of such representations, he is now estopped from denying the validity of the stock and his obligation to pay for it in full.

We think that he is not estopped to set up the nullity of the unauthorized stock. It is true that it has been held by this court that a stockholder cannot set up informalities in the issue of stock which the corporation had the power to create. Upton v. Tribilcock, 91 U.S. 45, 23 L.Ed. 203; Chubb v. Upton, 95 U.S. 665, 24 L.Ed. 523; Pullman v. Upton, 96 U.S. 328, 24 L.Ed. 818. But those were cases where the increase of the stock was authorized by law. The increase itself was legal and within the power of the corporation, but there were simply informalities in the steps taken to effect the increase. These, it was held, were cured by the acts and acquiescence of the defendant.

But here, the corporation being absolutely without power to increase its stock above a certain limit, no acquiescence of the shareholder can give it validity or bind him or the corporation. "A distinction must be made between shares which the company had no power to issue and shares which the company had power to issue, although not in the manner in which, or upon the terms upon which they have been issued. The holders of shares which the company has no power to issue, in truth had nothing at all and are not contributors." 2 Lindley, Part., 138; and see Lathrop v. Kneeland, 46 Barb., N.Y., 432; Mackley's Case, L.R., 1 Ch.D., 247. * * *

So in Zabriskie v. Cleveland, C. & C. R. Co., 23 How. 381, 64 U.S., 16 L.Ed. 488, this court, after holding the railroad company to be liable on certain bonds which it was alleged had been indorsed by the directors without lawful authority, added: "This principle does not impugn the doctrine that a corporation cannot vary from the object of its creation and that persons dealing with a company must take notice of whatever is contained in the law of its organization."

Upon the principles stated in these authorities, we are of opinion that the defendant in error is not estopped by any acts of his, to assert the invalidity of the stock issued in excess of the limit authorized by the charter, and to deny his liability thereon. * * *[7]

BELLE ISLE CORPORATION v. MacBEAN et al.

Court of Chancery of Delaware, 1946. 49 A.2d 5.

Suit by Belle Isle Corporation, a Delaware corporation, against T. Leonard MacBean, E. Jane MacBean, and Oakdale Contracting

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[7] See Berle, Corporate Powers as Powers in Trust, 1931, 44 Harv.L.Rev. 1049 (the power to issue stock is limited by the doctrine that such issue must be accomplished so that the interests of existing and prospective shareholders are protected).

See, Note, 1911, 11 Col.L.Rev. 265, on the unauthorized issue of corporate stock. On the liability of stockholders to creditors where there has been an irregular increase of corporate stock, see, Handley v. Stutz, infra, p. 274; Veeder v. Mudgett, 95 N.Y. 295, 1884; 1926, 39 Harv.L.Rev. 269.

Company, Inc., a New York corporation, for a preliminary injunction. Decree advised in accordance with opinion.

SEITZ, VICE-CHANCELLOR. The complainant corporation seeks a preliminary injunction to prevent the various defendants from exercising any of the rights of ownership in connection with certain shares of the complainant corporation's stock, allegedly owned by the defendants, pending the ultimate determination by this court of the complainant's right to have such shares cancelled, or to have certain monetary relief.

The application for the preliminary injunction was heard exclusively on affidavits which were of a magnitude to dismay even the most hearty. It was also apparent that the less than cordial relationship existing between the parties tended to result in more heat being generated than light shed.

The complainant Belle Isle Corporation, a Delaware corporation, filed a bill of complaint naming as defendants T. Leonard MacBean, E. Jane MacBean and Oakdale Contracting Company, Inc. (hereafter referred to as Oakdale). It is not disputed that E. Jane MacBean is the wife of T. Leonard MacBean, nor that Oakdale is dominated and controlled by T. Leonard MacBean. The reading of an earlier opinion of this court in other litigation involving these parties, among others, will aid in painting the background of this picture. See Appon et al. v. Belle Isle Corporation et al., Del.Ch., 46 A.2d 749.

Three separate issuances of the complainant's stock to the defendants are attacked in the bill of complaint, but for purposes of the complainant's application for a preliminary injunction we need only consider two of them. The first transaction involves the issuance of 75,000 shares to the defendant T. Leonard MacBean (actually 55,000 shares were issued to him and 20,000 shares to his wife, E. Jane MacBean) on June 5, 1944, pursuant to a resolution which was allegedly passed (denied by complainant) at a directors' meeting held June 3, 1944. Services rendered to the corporation by the defendant T. Leonard MacBean from 1928 to 1944 allegedly constituted the consideration for the issuance. The complainant corporation vigorously denies that there was in fact any such consideration, but I find it unnecessary at this time to determine this disputed question of fact.

* * *

The complainant corporation seeks to have cancelled the 75,000 shares of its stock issued to the defendant MacBean pursuant to authority allegedly given by resolution of the board of directors passed at a meeting held on June 3, 1944. The complainant asserts numerous reasons why the transaction was invalid and the defendant MacBean not only denies these contentions vehemently, but asserts several grounds in support of the legality of the issuance of the shares in question.

Many of the grounds asserted in support of and in opposition to the legality of the issuance of the 75,000 shares are premised upon facts which are seriously in dispute and which cannot properly be determined at this stage of the proceeding.

Aside from these grounds, however, the complainant corporation contends that no quorum was present at the June 3, 1944 directors' meeting when the issuance of the stock in question was allegedly authorized as partial compensation for MacBean's past services to the corporation. The defendant MacBean on the contrary contends that a quorum was present under conditions hereinafter discussed.

The following by-laws of the corporation were admittedly part of the written corporate by-laws at the date of the meeting held June 3, 1944:

"[Article II] Section 5. NUMBER AND QUORUM:—The number of directors shall be TEN. A majority of the directors shall constitute a quorum for the transaction of business. Directors need not be stockholders.

* * * * * * * * * *

"[Article V] Section 3. INCREASE OF NUMBER OF DIRECTORS:—The number of directors of the corporation shall be fixed by the By-Laws and shall not be altered except at a stockholders meeting by a vote of the stockholders owning 75% of the shares entitled to vote thereon. In case of any increase in the number of directors the additional directors may be elected by the directors, or by the stockholders at an annual or special meeting by a plurality vote."

Article II, Section 5 had been amended by a resolution of the stockholders adopted June 7, 1939, whereby the number of directors was increased from seven to ten. All parties concede that this increase was made in 1939 in order to provide for representation to the so-called Ware-Wasson group when it performed a certain agreement involving the corporation's stock. The so-called Ware-Wasson agreement expired June 30, 1940 without ever being carried out so that this group never was represented on the board of directors.

No meeting of the stockholders or of the board of directors of complainant corporation was held between June 30, 1940 (when the Ware-Wasson agreement expired) and June 3, 1944, the date on which the directors allegedly authorized the issuance of the 75,000 shares here involved. The importance of this time interval will appear.

It is conceded by the defendants that at the meeting of June 3, 1944 there were present only the following four directors: MacBean, Huppuch, Irish and Corcoran. And it is undisputed that at no time during the period with which we are here concerned was any formal amendment to the by-laws ever adopted changing the number of directors from the ten provided for by Article II, Section 5.

It necessarily follows that if the by-law provision calling for ten directors was operative at the meeting of June 3, 1944, then a quorum of directors under Delaware law as applied to the charter and by-laws of the corporation would be six directors. This is so because it was held in Bruch v. National Guarantee Credit Corporation, 13 Del. Ch. 180, 184, 116 A. 738, 740, that "The rule is that the number necessary to constitute a *quorum*, under a by-law such as appears in this case, is a majority of the entire board notwithstanding there may be vacancies in the board at the time." The pertinent by-law provision

of the corporation involved in the Bruch case was in substance identical with the complainant corporation's by-law governing quorum requirements, and, as a consequence, the quoted principle is operative.

As stated, only four directors were present at the June 3, 1944 meeting and one of these was the defendant MacBean. Passing complainant's contention that defendant MacBean, being interested in the transaction, could not be counted for quorum purposes, it is clear that even including MacBean for quorum purposes there was no quorum present at the June 3 meeting unless, as defendant contends, "by Established Practice to the Contrary Acquiesced in by the Stockholders", the quoted by-law (Article II, Section 5) was amended so as to provide for only seven directors.

The defendant MacBean's case turns then, at this time, exclusively on whether or not the corporation's by-law had been amended by custom so that at the June 3, 1944 meeting it had a board of seven directors rather than ten. Of course, if defendant MacBean is correct then, assuming MacBean could be counted, there was a quorum present at the June 3, 1944 meeting.

It is true, as defendant states, that in the case of In re Ivey & Ellington, Inc., Del.Ch., 42 A.2d 508, this court recognized the principle of amendment of corporate by-laws by a course of conduct inconsistent therewith. Clearly, however, one who contends that a written by-law has been amended by custom inconsistent therewith has the burden of establishing the existence of such a custom. Upon the undisputed facts, the defendant MacBean has failed to meet this burden, and it is not apparent that facts which would vary such a conclusion will be available to the defendant at the final hearing.

Almost dispositive of the defendant's contention as to the amendment by custom is the undisputed fact that *there was no meeting either of the stockholders or directors between June 30, 1940 and June 3, 1944.* The June 30, 1940 date of course represents the expiration date of the Ware-Wasson agreement, and clearly the by-law provision as to directors would not have been changed prior to that date, because the by-law provision was amended to increase the number of directors from seven to ten in order to effectuate in part the Ware-Wasson agreement. From June 30, 1940 to the directors' meeting date of June 3, 1944—when the issuance of the stock in question was allegedly authorized—no stockholders' meetings or directors' meetings were held. I cannot conceive how total stockholder and director inaction can form the basis for a custom inconsistent with a written by-law provision.

Obviously, if there was no meeting during the period mentioned, then defendant's assertion that directors owning the majority of the stock participated in directors' meetings, and thereby amended the by-law, can have no force, even if we assume that less than total stock representation may be sufficient. This is necessarily so because the directors' meetings where such stock was represented were held *after* the meeting of June 3, 1944, when the issuance of the stock in question was allegedly authorized. Defendant does not contend that the amendment by custom took place subsequent to the June 3, 1944

meeting. Moreover, the defendant MacBean's own actions at a meeting held March 28, 1945 reveal that he did not then consider that the by-laws had theretofore been amended by custom so as to provide for only seven directors. This is so because MacBean at that meeting "advised the meeting that three Directors should be elected to fill the present vacancies in the Board." Since there were admittedly seven directors in office in March of 1945, it is clear that the defendant MacBean assumed the written by-law providing for ten directors was still in effect.

Much reliance is placed by the defendant on the case of In re Ivey & Ellington, Inc., supra, but beyond recognizing the principle that a by-law may be amended by a custom inconsistent therewith, it gives little solace to the defendant. In the first place, the acts relied upon in the Ivey & Ellington case were necessarily inconsistent with the written by-law, because more directors were elected than were provided for by the by-laws, while here fewer directors were elected than were called for in the written by-law. Moreover, in the Ivey & Ellington case, the inconsistent acts, i. e., attending directors' meetings, were participated in by directors who owned all the corporate stock which possessed the right to amend the by-laws. As stated, such was not the case here. Even when confronted with such inconsistent acts, the Chancellor refused to conclude that the written by-law had been amended by custom to the contrary. While the Ivey & Ellington case recognized that the question of whether or not a by-law has been amended by custom inconsistent therewith is largely one of fact, nevertheless, it is apparent from undisputed facts here that the burden of showing such a custom has not been met.

I conclude, therefore, that at the June 3, 1944 meeting no quorum of the directors was present because a majority of the 10 directors required under the by-laws was not present. As a consequence, the resolution authorizing the issuance of the 75,000 shares of the complainant's stock to the defendant MacBean was in the language of this court in Mecleary v. John S. Mecleary, Inc., et al., 13 Del.Ch. 329, 332, 119 A. 557, 559, "illegal, because there was no *quorum* of the board present at the meeting authorized to transact business for the corporation."

The defendant MacBean contends that the issuance of the stock in question was ratified in two ways (1) because it was authorized by directors owning more than a majority of the stock and (2) because it was purportedly ratified at a subsequent directors' meeting held March 28, 1945, at which meeting the minutes of the meeting of June 3, 1944 were approved. As to the first contention, I do not believe that the fact that directors owning a majority of the stock vote in favor of certain corporate action can be substituted for the quorum requirements imposed by law. The defendant's second contention is likewise untenable because there was not a quorum of directors present at the March 28, 1945 meeting. Therefore, my ruling as to the June 3, 1944 meeting applies with equal force to the March 28, 1945 meeting. Certainly the quorum requirements for ratification are at least the same as they are for original authorization, other-

things being equal. Moreover, this court in the case of In re Chelsea Exchange Corp., 18 Del.Ch. 287, 159 A. 432, adopted the principle that when a board of directors approves an act which is void because the meeting of the board was illegal, the approval of the minutes of such meeting at a subsequent meeting is not an approval of such an unauthorized act. This principle is applicable to defeat any contention of an alleged ratification by approval of the corporate minutes, and this is so without deciding whether the word "void" properly describes the legal effect of the passage of the resolution under the circumstances mentioned. Nor can there be any so-called "informal" approval by the directors of this type of corporate act. See U. S. Fire Apparatus Co. v. G. W. Baker Machine Co., 10 Del.Ch. 421, 95 A. 294.

We are not here concerned with a person who is dealing at arm's length with the corporation because the defendant MacBean during the time in question was a director and officer of the corporation. As a consequence, the situation is comparable to an intra-corporate transaction and must be adjudged accordingly.

I conclude that the 75,000 shares were issued to the defendant MacBean without proper corporate authorization, but at this stage of the proceedings I will do nothing further than advise the issuance of a preliminary injunction which will render such shares available for subsequent disposition and will prevent the defendant from exercising acts of ownership over them. At the final hearing, consideration can be given to the terms, if any, upon which these shares should be cancelled. See, generally Peter v. Union Mfg. Co., 56 Ohio St. 181, 46 N.E. 894. In view of my conclusion, it is unnecessary to consider any of the other grounds advanced by the opposing parties with respect to the legality of the issuance of these shares. * * *

A decree accordingly will be advised.

(b) Subscription and Issue

NEW YORK STOCK CORPORATION LAW

§ 37. *Subscription and authentication of certificate.* A certificate filed pursuant to section thirty-six shall be either:

1. Subscribed and acknowledged by every subscriber of the certificate of incorporation and every subscriber to stock, and shall have annexed an affidavit by one of the subscribers of the certificate of incorporation to the effect that no stock has been issued and that the persons who have executed the certificate constitute all of the subscribers of the certificate of incorporation and all of the subscribers to stock; * * *

§ 67. *Subscriptions to stock.* If all the shares shall not have been subscribed for at the time of filing the certificate of incorporation, the directors may receive subscriptions payable in money until the shares are fully subscribed.

§ 68. *Time of payment of subscriptions to stock.* Subscriptions to the shares of a corporation shall be paid at such times and in such instalments as the board of directors may by resolution require. If

default shall be made in the payment of any instalment as required by such resolution, the board may declare the shares and all previous payments thereon forfeited, after the expiration of sixty days from the service on the defaulting stockholder, personally, or by mail directed to him at his last known post-office address, of a written notice requiring him to make payment within sixty days from the service of the notice at a place specified therein, and stating that, in case of failure to do so, his shares and all previous payments thereon will be forfeited.

Such shares, if forfeited, may be reissued or reoffered for subscription. If a receiver of the corporation has been appointed, all unpaid subscriptions shall be paid at such times and in such instalments as such receiver or the court may direct.

DELAWARE GENERAL CORPORATION LAW

Sec. 21. *Subscription to Corporate Stock; Directors May Open Books for: How Paid:*—At any time after a corporation is authorized to commence business, the directors may, if its whole capital stock has not been subscribed, increase its capital stock up to the amount authorized in its certificate of incorporation, and open books for additional subscriptions thereto.

The capital stock of a corporation shall be paid in such amounts and at such times as the directors may require. The directors may, from time to time, assess upon each share of stock not fully paid up, such sum of money as the necessities of the business may, in the judgment of the Board of Directors, require, not exceeding in the whole the balance remaining unpaid on said stock, up to the par value thereof, or in the case of stock without par value, not exceeding the consideration for which such stock was issued by the corporation, and such sum so assessed shall be paid to the Treasurer at such times and by such installments or calls as the directors shall direct, the said directors having given at least thirty days' notice of the time and place of such payments in a newspaper of the County in this State where such corporation is established, or has its principal place of business, or by written notice mailed at least thirty days before the time for such payment, to each stockholder at his last known postoffice address.

SUBSCRIPTION AND ISSUE

In the early days a "subscription book" was opened and circulated, each person agreeing to take up, say 50 shares and pay for the same at the rate of $100 per share. After a period of time the "subcription book" was closed and no further subscriptions were taken. The numerous changes that have been made in the corporation laws have made it possible to incorporate a company with great speed, a minimum amount of expense and considerable simplicity. This development made it unnecessary to take subscriptions from the public prior to incorporation and accordingly the machinery of the "subscription book" or the "subscription list" is seldom used today. Now, a banker

or private group usually subscribes for or agrees to purchase an entire lot of shares then to be issued, and resells these shares in smaller lots to his customers, or a promoter turns over property in return for a block of stock on original issue.

The various states are in conflict as to the effect of an ordinary subscription to shares in a corporation intended but not yet formed. The majority view appears to be that in such situations, a subscription is not a contract between the subscribers, but only a continuing offer to the corporation. Cramer v. Burnham, 107 Conn. 216, 140 A. 477, Collins v. Morgan Grain Co., infra. See Schwenk, Pre-Incorporation Subscriptions: The Offer Theory and—What Is an Offer, 29 Va. L.Rev. 460; Frey, Modern Development in the Law of Pre-Incorporation Subscriptions, 79 U. of Pa.L.Rev. 1005; Lukens, The Withdrawal and Acceptance of Pre-Incorporation Subscriptions to Stock, 76 U. of Pa.L.Rev. 423; Morris, The Legal Effect of Pre-Incorporation Stock Subscriptions, 34 W.Va.L.Q. 219; Simonton, Subscriptions to Stock in a Corporation to be Organized, 34 W.Va.L.Q. 76; Ballantine, Law of Corporations (1946) 442 et seq. Thus, a subscriber may revoke an offer at any time before acceptance. There is disagreement as to what constitutes an acceptance in those states following the "revocable offer" theory. Cramer v. Burnham, 107 Conn. 216, 140 A. 477; Cartwright v. Dickinson, 88 Tenn. 476, 12 S.W. 1030; Feitel v. Dreyfous, 117 La. 756, 42 So. 259; Richelieu Hotel Co. v. International Military Encampment Co., 140 Ill. 248, 29 N.E. 1044; Utah Hotel Co. v. Madsen, 43 Utah 285, 134 P. 577. The courts of other states however hold that a subscription is a contract between the subscribers as well as a continuing offer to the corporation. Coleman Hotel Co. v. Crawford, (Texas Com.App.) 3 S.W.2d 1109; Minneapolis Threshing Mach. Co. v. Davis, 40 Minn. 110, 41 N.W. 1026; O'Dell v. Appalachian Hotel Corp., 153 Va. 283, 149 S.E. 487. These courts, with considerable doctrinal difficulties, conclude that the offer to the corporation is irrevocable and therefore hold a subscriber liable despite revocation before acceptance. They do however have great difficulty in sustaining the right of the corporation to sue if the subscriber revokes or withdraws a subscription before the corporation has accepted his subscription.

As a matter of public policy it seems desirable that the newly formed corporation should have, as resources, enforceable subscriptions. Section 6 of the Uniform Business Corporation Act provides that subscription for shares signed before incorporation are irrevocable for a period of one year unless otherwise provided in writing. 9 Uniform Laws Ann. 85. They are revocable after that period unless prior to revocation the corporation has been brought into existence. Section 5 of the Uniform Act provides that all subscribers prior to the issuance of the certificate of incorporation, or their assigns, automatically become shareholders upon incorporation. 9 Uniform Laws Ann. 83, 84. Both of these provisions have been followed with some modification in several of the more recently enacted corporation acts. Calif.Civ.Code, § 322 (1); Illinois Business Corp.Act § 16; Michigan Gen.Corp.Law, § 5-2; Pa.Bus.Corp.Law, § 207.

The "control" system is the stock book—a book of certificates of stock with a stub not unlike a check book. Upon the issue of shares a certificate is issued for them to the subscriber or purchaser, setting forth his name, the number of shares he holds and his address. The number of shares held by him are entered on the stub. An alphabetical notation or "stock register" or "stock transfer book" is kept upon which appear in alphabetical order the names and addresses of the shareholders, and the number of shares they hold. Appropriate notations are made in blanks provided for the purpose when shares are transferred; that is, a note is made that the shares or part of them have been transferred, and note is made of the name of the transferee, who then takes his place in the stub of the "stock book" and the "stock transfer book." The stock certificate is evidence of the holder's stock ownership; but is not necessary to make him a stockholder.

UNITED STATES RADIATOR CORPORATION v. STATE.

Court of Appeals of New York, 1913.
208 N.Y. 144, 101 N.E. 783, 46 L.R.A.,N.S., 585.

[Appeal from a judgment of the Appellate Division, Third Department, which affirmed the Court of Claims dismissal of plaintiff's claim.

Suit to recover a sum paid by plaintiff under protest and without prejudice to its rights, for stock transfer stamps.

Plaintiff delivered a number of shares of its capital stock to each of four corporations in payment for certain assets of those corporations. The four corporations and a trust company entered into a voting trust agreement, the trust company to hold and vote all the transferred shares for a limited period. A certificate was issued by plaintiff to the trust company, which thus became the record owner for voting purposes. The trust company issued to each shareholder of the four corporations a certificate that he was the owner of a certain number of plaintiff's shares deposited with and held by the trust company, and might transfer the certificate. All dividends were to be paid to the certificate holders who, at the end of the voting trust agreement, were to be entitled to turn in the certificates and receive plaintiff's certificate for shares of stock.

The State Comptroller held that the trust company certificates were taxable under N.Y.Tax Law, § 270.[8] Plaintiff paid for the transfer stamps without prejudice to its rights, and now seeks to recover the sum paid.] [9]

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8 "There is hereby imposed and there shall immediately accrue and be collected a tax, as herein provided, on all sales, or agreements to sell or memoranda of sales, or deliveries, or transfers of shares or certificates of stock, in any domestic or foreign association, company, or corporation * * * whether made upon or shown by the books of the association, company or corporation, or by any assignment in blank, or by any delivery or by any paper or agreement or memoranda or other evidence of transfer or sale whether entitling the holder in any manner to the benefit of such stock or to secure the future payment of money or the future transfer of any stock, on each share of $100 of face value or fraction thereof, 2¢ * * * "

9 Statutory provisions authorizing and regulating the proceedings: N.Y. Tax Law, § 276, empowers the tax commissioner to ascertain whether any stock trans-

COLLIN, J. * * * A share of corporate stock is the right which the shareholder has to participate according to the number of shares in the surplus profits of the corporation on a division, and in the assets or capital stock remaining after payment of its debts on its dissolution or the termination of its active existence and operation. Plimpton v. Bigelow, 93 N.Y. 592; Jermain v. Lake Shore & Mich. So. Ry. Co., 91 N.Y. 483. It is created by the joint action of the corporation and the shareholder. It imports a contribution to the capital stock made by the shareholder and accepted by the corporation. When a corporation has agreed that a person shall be entitled to a certain number of shares for a consideration permitted by law and executed by the person, those shares come into existence and are owned by him. The statement in the certificate of incorporation or charter of the corporation that the capital stock is a designated amount divided into a certain number of shares, each of a named value, creates neither shares nor capital stock. It expresses the power of the corporation to acquire a capital stock. It creates potential shares which, transferred into actual shares by the acquisition of members and their payments, produce the money or property which, put into a single corporate fund, is the actual capital or capital stock on which the corporate business is undertaken and in which are the shares. It also fixes the sum of the payment necessary to create a share. The certificate of the corporation for the shares, or the stock certificate, is not necessary to the existence of the shares or their ownership. It is merely the written evidence of those facts. It expresses the contract between the shareholder and the corporation and his co-shareholders. But it is the payment, or the obligation to pay for shares of stock, accepted by the corporation, that creates both the shares and their ownership. Burrall v. Bushwick R. R. Co., 75 N.Y. 211; Christensen v. Eno, 106 N.Y. 97, 12 N.E. 648, 60 Am. Rep. 429; Southworth v. Morgan, 205 N.Y. 293, 98 N.E. 490; Buffalo & N. Y. City R. R. Co. v. Dudley, 14 N.Y. 336; Dayton v. Borst, 31 N.Y. 435; Flour City National Bank v. Shire, 88 App.Div. 401, 84 N.Y.S. 810, affirmed 179 N.Y. 587, 72 N.E. 1141. In the last case cited, Judge Hiscock, then Justice Hiscock, writing for the court, said: "The company having thus acquired property under an agreement to give therefor to various people certain interests or shares in its capital stock, we think that such latter persons, immediately upon the acceptance of transfers by the corporation, became entitled to and vested with said interests or shares, and that no further steps were necessary to accomplish this latter result. It may be admitted at once that ordinarily the corporation would issue certificates for these shares of capital stock, but it is too well settled to permit of doubt that said certificates would be merely representative of and not the real interest in the property and assets of the corporation constituting its actual capital stock." 88 App.Div. at page 405, 84 N.Y.S. at page 813. * * *

Judgment affirmed.

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fer tax imposed is unpaid and, if so, to enforce its recovery and any penalty incurred. Section 280 provides the procedure for refunding a tax erroneously paid. These two sections remain in the same substantial form.

COLLINS v. MORGAN GRAIN COMPANY.

Circuit Court of Appeals of the United States, Ninth Circuit, 1926. 16 F.2d 253.

Action at law by the Morgan Grain Company, Inc., against H. W. Collins. Judgment for plaintiff, and defendant brings error. Reversed, and cause remanded for a new trial.

RUDKIN, CIRCUIT JUDGE. This was an action by a corporation to recover a balance due on a stock subscription. There is little controversy over the facts. In the latter part of 1920, one Morgan, a grain dealer of San Francisco, conceived the idea of forming a corporation to take over the grain business then conducted by certain operators on the Pacific Coast. With this object in view, he consulted Collins, a grain operator in Oregon and the Pacific Northwest, and Sibley and Anderson, American managers for Wills & Sons of London, and proposed that Wills & Sons, Sibley, Anderson, Collins, and himself take stock in the proposed corporation. The proposition was looked upon with favor by Wills & Sons, and they directed their American managers to proceed to New York and meet one of their directors, to discuss the matter with Morgan. A conference was held in New York, attended by Morgan, Sibley, Anderson, and a director of Wills & Sons, and as a result of this conference Morgan wired Collins concerning the matter. The telegram is not in the record, but in response thereto Collins wired Morgan, agreeing to take $25,000 in stock in the proposed corporation, payable in installments.

Upon receipt of this message, Wills & Sons agreed to subscribe for 1,260 shares, Anderson and Sibley for 10 shares each, and Morgan for 625 shares, of the par value of $100 each. Sibley and Morgan then returned to San Francisco, and while at Chicago, on their return, two additional subscriptions were taken, one for 50 shares, the other for 25 shares. After the return of the parties to San Francisco, the Morgan Grain Company was organized under the laws of the state of Delaware, and Morgan became president of the company. Morgan reported to the board of directors that he had secured subscriptions to the capital stock as above detailed. The subscriptions were accepted by the board and a call of 25 per cent. was made. The call was paid, and certificates issued to the several stockholders for the number of shares paid in full. Thereafter a certificate for the remaining shares subscribed by Collins was tendered, but he refused to accept the certificate or to pay the additional subscription. This action followed.

Upon the trial in the court below the defendant offered to prove that, before the organization of the corporation or the acceptance of his offer to subscribe, he met Morgan and Sibley in San Francisco and informed Morgan that he withdrew his subscription, that if Morgan would consent to its cancellation he would subscribe for and take $5,000 of stock in the corporation, and that Morgan agreed to this. The court below ruled that this evidence was incompetent, and directed a verdict for the plaintiff. The judgment on the verdict is now before us for review.

The principal assignment of error is based on the ruling of the court excluding testimony tending to prove a revocation or cancellation of the subscription before the corporation was formed, and before the offer was accepted. Agreements to subscribe for stock of corporations to be formed in the future may assume different forms, with different results. For example, if an individual, acting singly and without co-operation with others, offers to take stock in such a corporation, all the authorities agree that the offer may be rescinded or revoked at any time before the corporation is formed and the offer accepted; this upon the familiar principle that it takes two parties to make a contract, and that, if one is not bound, the other is not, in other words, that a mere unaccepted offer cannot in the nature of things constitute a binding contract.

Again, such an agreement may assume a double aspect, as where a number of persons agree to form a corporation and to subscribe to its capital stock. Such an agreement constitutes a contract as between the subscribers themselves, operative at once, and it likewise constitutes a continuing offer to the proposed corporation, which, upon acceptance, becomes as to each subscriber a contract between him and the corporation. Some of the authorities hold that contracts of the latter class are irrevocable without the consent of all the parties thereto; but there is usually found in such cases some element of estoppel, which does not exist in the case at bar. But, without attempting to distinguish the present case from the cases so holding, we deem it sufficient to say that the cases relied on are not supported by the weight of authority.

"According to the weight of authority, a subscription may be withdrawn at any time before it is accepted by the corporation, whether made before or after the formation of the corporation, for the reason that until such acceptance there is no binding contract, because, until then, there is no agreement and no mutuality of object, and hence no consideration, and, in the case of subscriptions made before the corporation is formed, for the additional reason that, until it is formed, the other contemplated party to the contract is not yet in existence; nor, where this rule obtains, is a subscriber deprived of the right to withdraw under such circumstances because other subscribers have acted upon the strength of his subscription, nor because he has induced others to subscribe." 2 Fletcher, Cyc.Corp. 1225. [Citing cases.] * * *

The reason for the majority rule is well stated in Hudson Real Estate Co. v. Tower, 156 Mass. 82, 30 N.E. 465, 32 Am.St.Rep. 434:

"At the time when the defendant signed the subscription paper declared on, it was not a contract, for want of a contracting party on the other side; but it has now been established that a subscription of this sort becomes a contract with the corporation when the corporation has been organized, and in this way the objection of the want of a proper contracting party is finally avoided, provided everything goes on as contemplated without any interruption. Until the organization of the corporation, the subscription is a mere proposition or offer, which may be withdrawn, like any other unaccepted offer. Un-

less the signer is bound upon a contract, he is not bound at all. It is open to him to withdraw. It is not on the ground that there was no sufficient consideration. The seal would do away with any doubt on that score. But it is on the ground that for the time being, and until the corporation is organized, the writing does not take effect as a contract, because the contemplated party to the contract, on the other side, is not yet in existence, and for this reason, there being no contract, the whole undertaking is inchoate and incomplete, and since there is no contract the party may withdraw."

Again, in Bryant's Pond Steam-Mill Co. v. Felt, 87 Me. 234, 32 A. 888, * * *, in reference to the minority rule, the court added:

"It is urged by the counsel for the plaintiff corporation that such subscriptions create binding and enforceable contracts between the subscribers themselves, and are therefore irrevocable, except with the consent of all the subscribers, and some of the authorities cited by him seem to sustain that view. But we find on examination that such views, when expressed, are in most cases mere dicta, and that the cases are very few in which such a doctrine has been acted upon. Reason and the weight of authority are opposed to such a view. Of course, subscription papers may be so worded as to create binding contracts between the subscribers themselves. But we are not now speaking of such subscription, or of voluntary and gratuitous subscriptions to public or charitable objects, which, when accepted and acted upon, become binding. We are now speaking only of subscriptions to the capital stock of proposed business corporations. With regard to such subscriptions, we regard it as settled law that they do not become binding upon the subscribers till the corporations have been organized, and the subscriptions accepted, and that till then the subscribers have a right to revoke their subscriptions. And in view of the fact that such subscriptions are often obtained by over persuasion, and upon sudden and hasty impulses, we are not prepared to say that the rule of law which allows such a revocation is not founded in wisdom. We think it is."

We give adherence to the majority rule, not only because it is best supported by authority, but because it is supported by the sounder reasoning as well. It is contended by the defendant in error that the ruling of the court below rejecting the testimony was not excepted to, or that the exception was insufficient, but with that contention we are unable to agree. The court below treated the exception as sufficient and gave full consideration to the case on the merits, on the hearing of the motion for a new trial, and this court will follow the same course. * * *

For the foregoing reasons, we are of opinion that the court below erred in excluding the testimony tending to show a revocation or cancellation of the subscription before the corporation was formed and before the offer was accepted, and for this error the judgment is reversed, and the cause is remanded for a new trial.

WINSTON et al. v. DORSETT PIPE & PAVING COMPANY.

Supreme Court of Illinois, 1889. 129 Ill. 64, 21 N.E. 514, 4 L.R.A. 507.

MR. JUSTICE MAGRUDER delivered the opinion of the Court:

This is a bill filed by the appellant, F. H. Winston, as a stockholder in the Dorsett Pipe and Paving Company, a corporation organized under the laws of this State, against said company, and its creditors, and the other stockholders, all of whom are parties defendant to this proceeding. The bill seeks the dissolution of the corporation, the appointment of a receiver, the sale of the corporate assets, the assessment of the shareholders, and the payment of the creditors.

The company was organized in 1881 with an authorized capital of $125,000 divided into shares of $100 each. Among the original subscribers to the stock, who participated in the organization, were * * * F. H. Winston, 50 shares, $5,000; * * * I. S. Waterman, 100 shares, $10,000; I. S. Waterman, trustee, 637 shares, $637,-000. Waterman died before the filing of the bill, and his executors were defendants in the court below. * * * The appellees * * * are the executors of Waterman's estate. None of the creditors and none of the stockholders, except (Winston, Stockton, and Chase) complain of the decree of the Circuit Court.

The decree assesses the whole amount of the indebtedness, found to be due, against all the stock, subject to assessment, except that known as the "Waterman trustee stock", amounting originally to 637 shares. It is only this feature of the decree which the appellants complain of. They claim, that the trustee stock should have been made to bear its *pro rata* share of the indebtedness, and that, by the failure of the court below to assess it, along with the rest of the stock, they are compelled to contribute more than their fair proportion towards the discharge of the debts of the company.

The original subscribers to the stock, besides those already named, were D. H. Dorsett, 250 shares, $25,000.00; I. P. Ellacott, 10 shares, $1000.00; F. S. Winston, Jr., 3 shares, $300.00. After 613 of the 1250 shares had been subscribed for, there was nobody to take the remaining 637 shares. It was deemed advisable to organize the corporation at once, and to proceed with the business as soon as possible. Under the statute a certificate of organization could not be obtained from the Secretary of State, until the capital stock should be fully subscribed. Accordingly it was suggested, at the gathering of the original subscribers above named, and while they were engaged in signing their names to the subscription paper, that Waterman, who was the prime mover and chief promoter of the scheme, should subscribe for the 637 shares, as trustee. In pursuance of this suggestion he signed the list: "I. S. Waterman, trustee, 637 shares, $63,700." The caption of the paper, so signed by him and the others, is as follows: "We, the undersigned, hereby severally subscribe, for the number of shares set opposite our respective names, to the capital stock of the Dorsett Pipe and Paving Company, and we severally agree to pay the said company for each share the sum of one hundred dollars."

There is some uncertainty expressed by some of the witnesses as to the persons, for whom Waterman was acting as trustee when he so signed his name. We deem it unnecessary to consider whether he was technically a trustee for the corporation, or for the stockholders, or for the future distributees of the stock. After a careful examination of all the evidence we are satisfied, that there was a definite understanding between him and the other subscribers, as to the purpose for which he took the stock, and as to the nature of the liability, which he assumed thereby. It was understood, that, after the report should be made to the Secretary of State, and the complete organization of the corporation should be effected, Waterman should go to work to dispose of the stock to third parties, and that the other stockholders should help him to so dispose of it. As between him and his co-stockholders, he was not to be liable upon the stock, and was not to be required to pay assessments upon it. It was explained to him and he was fully aware, that, as between him and creditors of the company, he would be held liable upon his subscription for the 637 shares. * * *

As between the State and Waterman, he must be regarded as a subscriber for the 637 shares. If he and those associated with him reported a fictitious or unreal subscription for the trustee stock, they obtained a charter from the State by fraud. There is no evidence of any such intention or design on the part of the gentlemen, who organized this corporation.

As between the creditors of the company and Waterman, he must be regarded as a subscriber for the 637 shares. The fact that he placed the word "trustee" after his name would make no difference in his liability to the creditors. "Where shares are held by a person as trustee for another, the legal holder of the shares, and not the equitable owner, is primarily liable both to the company and to its creditors." 2 Morawetz on Corp. § 853. Appellees admit that the estate of Waterman is liable to be assessed upon the shares held by him as trustee, if such assessment becomes necessary in order to pay the debts of the corporation. The rights of the creditors in this regard are recognized by the decree of the trial court.

But, in view of the understanding among the stockholders that the trustee stock should not be subject to assessment as between Waterman and the original subscribers, the Circuit Court, by its decree, makes an assessment against the stock, other than the trustee stock, reserving the right to make further assessments if the same shall be needed. The decree provides that "in case money enough cannot be realized from the assessments upon the stock, which is liable to contribute to and be assessed as aforesaid for the payment of the valid debts and obligations of the said corporation, then the said executors of said James S. Waterman, deceased, shall be required to pay also, upon the said stock taken by James S. Waterman as trustee, such sum as may be necessary to pay said deficiency." The executors are assessed upon the $10,000.00 of stock, subscribed for by Waterman individually.

We cannot see why, under the facts disclosed by this record, the decree of the court below is erroneous in holding, that the trustee stock should not be assessed primarily and in the first instance, as between these three appellants and the Waterman estate. The decree does not require the appellants to pay more than they owe. Neither of them ever paid his subscription to the capital stock in full. Unpaid subscriptions to the capital stock of a corporation constitute a trust fund, which may be subjected to the payment of the debts, like any other asset. The assessments made by the present decree against the appellants respectively do not exceed, or equal, the several amounts due from them upon their unpaid subscriptions. There is no hardship in requiring them to carry out the arrangement as to the trustee stock, made with Waterman in their presence and with their consent, and of which they reaped the benefit by a speedy organization of the Pipe and Paving Company.

In most of the cases, where subscriptions to the capital stock of corporations have been condemned, as being conditional, or accompanied by secret or qualifying agreements, the rights of creditors or stockholders have been prejudiced. Creditors are entitled to look to the stock as it appears upon the face of the subscription list. Each stockholder has a vested right in the contract for subscription of every other stockholder. In the case at bar, no creditor is injured, and no creditor is complaining. The appellant stockholders cannot object to the release of stock, which they permitted to be subscribed for with the understanding that, so far as they themselves were concerned, it should be released. We are of the opinion that the Appellate Court committed no error in affirming the decree of the Circuit Court.

The judgment of the Appellate Court is, therefore, affirmed.

Judgment affirmed.

BURNINGHAM v. BURKE et al.

Supreme Court of Utah, 1926. 67 Utah 90, 245 P. 977.

Action in equity by H. I. Burningham against J. J. Burke, receiver, and others. Judgment for defendants, and plaintiff appeals. Reversed, and remanded for new trial.

STRAUP, J. This is an action in equity, brought by the plaintiff, the appellant, to rescind a subscription or purchase of capital stock and to recover back moneys paid by him thereon. [The basis of his suit was fraud. At the conclusion of plaintiff's evidence, the court granted defendant's motion for a nonsuit.] * * *

Upon the question of laches, we think the evidence was not of such character as to preclude the plaintiff from recovery. Indeed, on the record, we think the evidence is not sufficient to even justify a finding that the plaintiff was guilty of laches, much less that he was conclusively guilty thereof. There is evidence to show that some of the alleged material representations were made, that they were false, that the plaintiff relied on them, and that he did not discover their falsity

until after the appointment of the receiver, and that in no particular was he connected with or participated in any of the affairs of the company or attended any stockholders' or other meetings of the company, or otherwise took part in any of the proceedings of the company, or had any knowledge of or familiarity with the business, or received any dividends or other benefits whatsoever, or that he was negligent in not earlier discovering the alleged fraud or misrepresentations. Nor on the record can we say as matter of law that the plaintiff, after discovering the fraud, did not act with reasonable diligence and promptness in rescinding or repudiating his contract of purchase. * * * Whether one on the ground of fraud or misrepresentation may rescind or repudiate a stock subscription or purchase after the corporation has become insolvent or after the appointment of a receiver, judicial opinions are in irreconcilable conflict. We, however, believe the weight of American authority to be that a rescission or repudiation on such ground may be made after the corporation has become insolvent or the appointment of a receiver, if the person making it was not guilty of laches, and acted promptly and with reasonable diligence, and otherwise was entitled to rescind or repudiate. The difficult question is: May he do so when a considerable amount of indebtedness has been incurred by the corporation subsequent to the stock subscription or purchase and before the insolvency of the company or the appointment of the receiver? The authorities as to this also are in conflict. * * *

It will be seen that in some of the cases relief was denied on the theory of the "trust fund doctrine," by reason of which it is asserted that the equities of creditors are superior to those of a defrauded shareholder. * * *

As to subsequent creditors, we, upon what we regard to be the weight of authority, deduce this: Where one subscribed for or purchased stock of a solvent corporation, he, on the ground of fraud or misrepresentation, may rescind or repudiate the contract, if otherwise entitled to do so, and is not guilty of laches, even after the corporation has become insolvent or has gone into hands of a receiver, except as to subsequent creditors, who, in ignorance of the fraud and on strength of or reliance on the stock subscription or purchase in good faith and in some considerable amount, became such thereafter and before the insolvency of the company or appointment of the receiver, to show which the burden is on the receiver or such subsequent creditors.

In such view, looking at the evidence in the light most favorable to the plaintiff, we find this to be the situation: When the stock was purchased by plaintiff, the company then had current liabilities of about $368,000 and numerous creditors, about 150 of whom were creditors on open and running accounts. Such creditors, after plaintiff's purchase of stock, continued as they had before to carry on an open running account with the company until or shortly before the appointment of the receiver. It is claimed by the respondents that between such time the aggregate amount of corporate debts incurred with such creditors was about $82,000. But in about every instance the company, at the time of plaintiff's purchase of stock, was indebted to such creditors as much as, and, in some instances, more than, when the receiver was appointed. * * *

Independent of other evidence, or other facts or circumstances, it is rare where, from the mere fact of a stock subscription or purchase and the incurring of corporate indebtedness thereafter, a conclusive presumption may be indulged that such debt or debts were incurred on reliance of stock subscription or purchase. To give a subsequent creditor equities over a defrauded stockholder, it is not essential that it be shown by direct evidence that the creditor or creditors relied on the stock subscription or purchase; but, to justify such reliance, there ought to be shown some facts or circumstances in addition to the mere fact that a substantial amount of debt was incurred or credit given subsequent to the stock subscription or purchase. There were no new creditors; but that is not controlling. An old creditor on reliance of stock subscriptions or purchases may, subsequent thereto, extend further or additional credit just as a new creditor may on such reliance extend credit. There may be here some subsequent creditors who have equities superior to those of the plaintiff, but on the record, and because of the nature and character of the subsequent indebtedness and the manner in which it was incurred, no such conclusive presumption as to any of it should be indulged as was done by the trial court as to all of it, and the plaintiff denied all relief. The difficulty here is that all debts incurred subsequent to plaintiff's stock subscription, no matter what amount or nature or how incurred, * * * were grouped and treated as of equal standing and equity, and the conclusive presumption indulged that all were incurred on strength of and reliance on plaintiff's and other stock subscriptions and purchases, and all such creditors treated as having equities superior to those of plaintiff, who was sent out of court and his action dismissed—dismissed not only as to subsequent creditors, but also as to all creditors existing at the time of his purchase—and plaintiff forbidden in any particular from participating with them or at all or on any condition in any of the assets of the company, and thereby all claims of prior as well as subsequent creditors adjudged superior to those of the plaintiff, and thus, stripped of all rights in the premises, the court turned him out naked even as against the corporation itself who, as alleged and as shown by evidence, defrauded him. In other words, by the ruling, the trial court made no distinction whatever as to prior or subsequent creditors, and in such respect even exceeded the terms of the pleaded estoppel which declared an estoppel only as to subsequent creditors. However, the ruling in such regard is now defended on the ground that the aggregate amount of subsequent debts incurred greatly exceeded the amount of plaintiff's purchase. But the aggregate amount of subscriptions and purchases during the stock-selling campaign greatly exceeded the aggregate amount of such indebtedness, even though the whole of the $82,000 indebtedness should be regarded as corporate indebtedness incurred on reliance of such stock subscriptions or purchases, which, on the record, is not justified. * * *

Substantially all the authorities agree that, in an action brought by a defrauded stockholder to rescind his stock subscription or purchase, the equities of subsequent creditors is matter of defense and must be pleaded. It here was pleaded by the receiver. * * *

So our ruling is that the defense of equities of subsequent creditors was properly interposed by the receiver. At the same time we see no reason why such subsequent creditors, if they choose to do so, may not, upon a proper showing, intervene in an action such as here. Though equities of subsequent creditors be, in an action of this kind, determined against him, the plaintiff, nevertheless, on issues as here, was entitled to have adjudicated his demand and damage, and if found in his favor, to have declared the amount thereof entitled to participate in the assets of the company upon a basis of equality with existing creditors at the time of his purchase, except as to secured or otherwise preferred creditors. Because on evidence and the record in a case it may be found and determined that equities of subsequent creditors are superior to those of the plaintiff, still, for such reason, existing creditors who, as against the plaintiff having no equity ought not to be placed in a better condition than occupied by them before the appointment of the receiver had there been no subsequent creditors.

Let the judgment of the court below be reversed, the case remanded, and a new trial granted. Such is the order. Costs to the appellant.

POST INCORPORATION SUBSCRIPTIONS

Subscriptions for shares made after a corporation is formed have the legal effect of making the subscriber an owner of the shares immediately, even though the rights of a shareholder of record may be withheld as security. Neither the issuance of certificates evidencing the shares nor the payment of price are a necessary prerequisite. The subscriber therefore becomes liable as a debtor to pay the subscription price for the shares.

Difficulty and confusion arise from the attempt by many courts to distinguish between contracts for the issue of shares by way of subscription and by way of purchase and sale. In so distinguishing the courts resort to the law of contracts trying to determine the intention of the parties and to interpret the terms of the particular agreement. The usual situation in which this distinction has been applied is where the purchase price is payable over a period of time. Stern v. Mayer, 166 Minn. 346, 207 N.W. 737; Reagan v. Midland Packing Co., 298 F. 500 (D.C.Iowa 1924). Ballantine indicates that the principal consequences of determining that an agreement is not a subscription but an executory contract of purchase are as follows:

"(1) The promise to issue the shares and the promise to pay the price are considered to create dependent and concurrent duties. Tender of a certificate for shares, or the ability and willingness to deliver a certificate on payment, are a condition to the right of a corporation to bring suit for the purchase price. Payment is a condition to the right to a certificate for shares and the status of a shareholder.

"(2) The purchaser is not a debtor and according to some courts the measure of liability of the purchaser if he defaults, is in damages for the difference between the contract price and the market value of the shares.

"(3) The most serious consequence of all is that bankruptcy or insolvency of the corporation will terminate its claim against the pur-

chaser on the theory that it can no longer perform its side of an executory contract by delivery of a valid certificate and that the consideration has failed." (Ballantine Corporations, 1946 Ed., p. 451.)

It would seem better to disregard these refinements of contract law and hold that any agreement for issuance or creation of shares is a subscription and carries with it the unqualified obligation to pay the subscription price. The Minnesota Business Corporation Act, adopted in 1933, by statute provides in section 16-xi that contracts to purchase shares from the corporation shall for all purposes have the same status as accepted subscriptions.

2. STOCK TRANSFER AGENT AND REGISTRAR

STOCK TRANSFER AGENT AND REGISTRAR

When a stockholder transfers his shares of stock, the corporation accepts the properly assigned certificate, cancels it, makes the necessary entry upon its books and issues a new certificate to the assignee. Formerly, the company did no more than permit the stockholder to open the books and record the transfer of interest himself; but today the agent of the corporation, in effect, is appointed the attorney of the transferor for this purpose.

This "very simple business"[10] has acquired amazing complexity; and in recognition of the mechanical and legal skill required for its performance, most corporations with publicly held shares have delegated the tasks of stock issue and transfer to banks and trust companies. These professional agents are customarily designated by a resolution of the board[11] which frequently limits the authority granted according to the form of appointment suggested by the agent.[12] Some firms, among them General Motors and the Texas Company, perform the operation of transfer within a department of their own company.

Trust companies and banks engaging in stock transfer activities are also available for agency appointment as registrar. It is the duty of the registrar to act as a check upon the transfer agent and to prevent the negligent or fraudulent overissue of stock. Obviously, one cannot serve in both capacities for the same principal, nor can any company trading on the national exchanges act as registrar for its own stock.[13]

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10 "* * * What is a transfer agency? It is a very harmless thing. It amounts to nothing more than the witnessing of the conveyance by one person to another, of personal property, viz. stock of an incorporated company; and in this case also to furnishing the purchaser a certificate of ownership of such stock, on the surrender of a previous certificate of like character held by the seller. This is a very simple business, involving little or no risk or hazard; requiring nothing but ordinary care and fidelity in its performance." Bank of Kentucky v. Schuylkill Bank, 1 Parsons Eq.Cas. (Pa.) 180 (1846).

11 Fletcher, Cyclopedia of the Law of Private Corporations, V. 19, sec. 8932.

12 Christy, The Transfer of Stock (2d ed. by Christy & McLean, 1940) sec. 282. See Chap. XVIII which is devoted to the functions of the transfer agent and registrar and includes a description of the activities of the transfer agent other than the issue and transfer of stock. The transfer agent frequently will make dividend disbursements, and, through a corporate agency department, may act as subscription agent, depositary under readjustment and consolidation plans, redemption agent, etc.

13 e. g., Requirements for Listing on the New York Stock Exchange.

The need for a registrar first appeared in the 1860's when a transfer agent and officer of the New York and New Haven Ry. fraudulently issued certificates of stock in the company endangering its financial soundness.[14] Shortly afterwards the fight for control of the Erie railroad, which was accompanied by excessive stock issues through the circulation of convertible bonds, so concerned the New York Stock Exchange that provision for registration of securities was made a condition of listing.[15] Today the rules of the Stock Exchange require that the registrar must be a bank or trust company, and that neither registrar nor transfer agent can be changed without the approval of the Exchange.[16] The bank which seeks to qualify as transfer agent or registrar must not only show possession of the necessary facilities and undergo investigation, but it must agree with the Registration Division that "it will not * * * register as Registrar any securities dealt in on said Exchange to a greater amount than has been authorized by said Exchange; that it will not register any additional amounts of such securities until so authorized; and that it will promptly notify said Exchange of all such securities issued by it as Transfer Agent other than upon transfer. (Form 87A-7-37, N. Y. Stock Exchange.)"

As registrar the bank is not concerned with the propriety of a transfer of stock except to make certain that for each certificate issued there is either a cancelled certificate or an authorization from the transfer agent for a new issue.[17] It is very much concerned with the

14 N. Y. & N. H. R. Co. v. Schuyler, 34 N.Y. 30 (1865).

15 Resolution of the New York Stock Exchange and the Open Board of Stock Brokers, 30 Nov. 1868: "Whereas, Companies, whose stocks are actively dealt in at the New York Stock Exchange and Open Board of Brokers, have made secret issues of stock, without giving to the public information as to the amount or purpose of such issues, thereby endangering the interests of those who purchase or loan upon such stocks. * * * Resolved, * * * neither board will call, or deal in any active speculative stock, of any company, a registry of whose stock is not kept in some responsible Bank, Trust Co., or some other satisfactory agency, and which shall not give public notice at the time of establishing such registry, of the number of shares so entrusted to be registered and shall not give at least thirty days notice through the newspapers, and in writing to the President of each Board, of any intended increase of the number of shares, either direct or through an issue of Convertible Bonds, and shall not, at the same time, give notice of the object for which such issue of stock or Bonds is about to be made. * * *"

The resolution also called for the appointment of a committee authorized to request those companies whose securities were already traded in upon the exchange to appoint such a registrar. In January of the following year the Stock Exchange adopted a law requiring all companies to register their shares with a satisfactory agency. Erie refused to comply and was dropped from the trading list. The National Stock Exchange or "Erie Board" which was then established lasted until September at which time Erie registered its stock and was relisted by the Stock Exchange. See Schultz, The Securities Market and How It Works (1942) p. 11.

The substance of the resolution has appeared in different places in the revisions of the Constitution of the Stock Exchange (Constitution of 1892, Art. XX; Constitution of 1902, Art. XXXIII). It remained a part of the rules of the governing committee until 1923 and is now incorporated in the requirements of the Department of Stock List.

16 Instructions as to Transfer and Registration of Stock, N. Y. Stock Exchange, Department of Stock List, 12 Sept. 1939. For similar requirements on other exchanges see Behrends and Elliott. Responsibilities and Liabilities of the Transfer Agent and Registrar, 4 So.Cal.L.Rev. 203 (1931).

17 See Christy, sec. 280. For example, The Chase National Bank, when acting as registrar, follows the customary procedure of communicating with the transfer agent as soon as it finds that any number in the sequence of certificates submitted for registration has been skipped.

maximum issue authorized, and on the basis of the Certificate of Incorporation, the By-laws and other documents provided by the corporation principal sets up control books so that it may make certain that no stock is issued in excess of this amount.[18] The registrar makes no record of the names of stockholders. It completes its task by signing the new certificates and returning them with the cancelled old certificates to the transfer agent for delivery.[19]

While the responsibility of the bank when acting as registrar is very heavy, its duties are largely mechanical. This description does not apply to the duties of the transfer agent, however. Since title passes as between the transferor and transferee by assignment and delivery of the certificate, it might be supposed that the duty of the transfer agent would be largely ministerial and would extend only to verifying the proper execution of the assignment and duly entering the transfer upon the stockholders' accounts. Unfortunately, this is not the case. The transfer agent must make certain not only that the assignment has been validly executed but, in many cases, that the assignor has the capacity to make the transfer[20] and the assignee the power to hold the stock. This is the duty the professional transfer agent assumes to perform for the corporation.

The obligation of a corporation to consider the propriety of a transfer of its stock stems, according to Christy, from a doctrine established by Taney[21] which marked the course the American law of stock transfer was to follow. Aside from describing the function of the corporation in stock transfer as an exercise of a trust duty, the court placed upon it the duty of taking notice of beneficial as well as legal interests in its stock. Although it is a mere intermediary in a transaction between others, the corporation was made to satisfy the same requirement of investigation that is placed upon those who deal at a profit with a trustee.[22]

Thus, today, the corporation with any knowledge of a limitation upon the power of the legal holder will be liable in conversion or for damages for making a transfer where the assignor has exceeded his authority.[23] This liability is based upon the theory of participation

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18 Where a corporation has two or more transfer agents and registrars and stock may be issued and registered at more than one location, it is necessary for the co-registrars to inform one another by daily advices of the registration of new issues and so to keep a continuous check for agreement between their separate control books.

19 A description of the procedure followed can be found in Christy, sec. 284. The members of the New York clearing house make use of its facilities for the delivery of certificates between transfer agent and registrar.

20 Behrends and Elliott, note 16, *supra*, p. 209. See Kentucky Utilities Co. v. Skeggs, 293 Ky. 622, 169 S.W.2d 809 (1943).

21 Lowry v. Commercial & Farmers Bank, Fed.Cas.No.8,581 at p. 1047 (1848).

22 Christy, sec. 2.

23 King v. Richardson, 136 F.2d 849 (C.C.A.4th, 1943) (Corporation liable for permitting a transfer from a testamentary trust); Aronson v. Bank of America N. T. & S. A., 42 Cal.App.2d 710, 109 P.2d 1001 (1941) (Corporation a converter where transferor was known to be an agent and had limited authority); First Nat. Bank v. Pittsburg, F. W. & C. Ry. Co., 31 F.Supp. 381 (D.C.E.D., Pa.1939) (Stock in name of trustee as such transferred by corporation at its peril); Seymour v. Nat. Biscuit Co., 107 F.2d 58, certiorari denied 309 U.S. 665, 60 S.Ct. 590 (1939) (Corporation liable to remainder-man for effecting transfer from life tenant to broker); West v. American Tel. & Tel., 121 F.2d 142 (C.C.A.6th, 1941) conform-

in a breach of trust.[24] It follows that the transfer agent must require that an assignment by a trustee be supported by a copy of the trust instrument or court order,[25] and that an assignment to or by an executor or an administrator be accompanied by a copy of the will or probate order.[26] The transfer agent must be familiar with the laws of descent and distribution and those governing the powers of executors and administrators in every jurisdiction.

A Uniform Fiduciaries Act has been adopted in some eighteen states[27] with the purpose of exempting corporations from liability where transfers are made in breach of trust unless actual notice of the breach exists. Its aim is to relieve the company of the necessity for making inquiry. However, the act applies only to securities issued after its passage and, generally, does not cover the situation in which the certificate is actually held in the name of someone other than the fiduciary. It falls far short of the English law which relieves the corporation of the duty of taking notice of the trust itself. Furthermore, whatever its value, its limited adoption, like that of the Uniform Stock Transfer Act, leaves the transfer agent with a considerable problem in the conflict of laws.[28]

It would seem that the corporation might avoid liability by refusing to make a questionable transfer. But in Gillies v. Robert E. Lee Mining Co.[29] the corporation, which refused transfer unless the transferee would submit affidavits other than her own, showing that the transferor was alive (as required by statute), was held responsible for conversion of the stock. And, again, in London P. & A. Bank v. Aaronstein[30] although the court agreed with the company that the plaintiff (an executrix) was not the owner of the stock, it was held that transfer was necessary to the administration of the estate and that the company was a converter in denying a transfer to her. So,

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ing to mandate, 311 U.S. 223, 61 S.Ct. 179, 85 L.Ed. 139, 132 A.L.R. 956 (1941) (Corporation required to protect remainderman after issuing certificate to life tenant without showing limitation). [See Kentucky Utilities Co. v. Skaggs, 293 Ky. 622, 169 S.W.2d 809 (1943) in which it was held that the corporation properly refused transfer when request gave evidence of mental incompetence.]

24 Scott, Participation in a Breach of Trust, 34 Harv.L.Rev. 454 (1939); Corporate Liability for Registration of Unauthorized Fiduciary Transfers of Stock, 48 Yale L.J. 92 (1938); Liability of a Corporation for Registering an Unauthorized Transfer of Shares Standing in the Name of a Fiduciary, 86 U. of Pa.L.Rev. 653; Christy, Chap. XXI. Christy distinguishes such transfers from those in which the assignment is unauthorized by the legal holder. The latter class of transfers is analogous to that in which the indorsement is forged. An altered or forged assignment passes no title to the assignee. (Nat. Surety Co. v. Indemnity Ins. Co. of North America, 237 App.Div. 485, 261 N.Y.S. 605 (1st Dept. 1933), but a corporation which issues a new certificate on cancellation of the old will probably have to recognize or compensate both the original holder and any bona fide purchaser of the new certificate. Christy, secs. 242, 243.

25 Christy, Chap. XI.

26 Christy, Chap. IX; Escat v. Leaman, 181 So. 621 (La.App.1938). Where no probate is required, the transfer agent may demand affidavits and an indemnity bond by the transferee.

27 Christy, Chap. XVII. New York Gen.Bus.Law, secs. 359-j and 359-k.

28 Anno: Conflict of laws as to title and transfer of stock, 131 A.L.R. 192 (1941).

29 78 Mont. 402, 254 P. 422 (1927).

30 54 C.C.A. 663, 117 F. 601 (1902), certiorari denied 187 U.S. 641, 23 S.Ct. 841, 47 L.Ed. 345.

it is apparent that the transfer agent must weigh carefully the conflicting claims to stock, for refusal to transfer may prove as costly an error as a wrongful transfer.[31] Usually, where the owner of a certificate which is indorsed in blank reports it lost or stolen, the transfer agent will require an indemnity bond before it will place a stop against its subsequent transfer.[32] This procedure clearly is proper where the Uniform Stock Transfer Act applies.[33] But the corporation will be liable for cancelling a certificate on which the assignment is forged or unauthorized.[34] And it will not be relieved of this liability by reason of its having relied upon the signature guarantee which it requires on all assignments.[35]

It is apparent that the professional transfer agent is assuming a heavy burden in contracting to perform this operation for the corporation in compliance with the law. Certainly it would be liable for failure to exercise reasonable care in the discharge of this duty.[36] It also will have direct responsibility for seeing that the various stock transfer taxes are paid and that inheritance tax waivers are secured.[37] Whether or not it is responsible to the individual stockholder for negligence in transfer, however, is another matter. Except for susceptibility to proceedings in equity to compel transfer it has been said that the transfer agent cannot be held liable to the stockholder for refusal to transfer—for mere nonfeasance.[38] However, an action may

31 See Dewey, The Transfer Agent's Dilemma: Conflicting Claims to Shares of Stock, 52 Harv.L.Rev. 553 (1939); Christy, Chap. XXII; Anno: Refusal of Corporation to issue, convert or transfer stock as conversion, 54 A.L.R. 1157 (1928); Anno: Right or duty to refuse to transfer stock on books to one presenting properly indorsed certificate, because of knowledge or suspicion of conflicting rights, 139 A.L.R. 273 (1942).

32 In Van Schaick v. National City Bank of N. Y., 245 App.Div. 525, 283 N.Y.S. 372 (1st Dept. 1935), the transfer agent was held not liable for failure to stop transfer of certificate which had been stolen and which was presented to it by a bona fide purchaser after it had received notice of the loss. The customary procedure of The Chase National Bank on receiving notice of loss is to send the loser a form letter which includes the remark, "Unless within a reasonable time after we send such notification (of receipt of the lost certificate for transfer) we are furnished with a bond of indemnity issued by an approved surety company indemnifying us and the Corporation against any loss occasioned by our refusal to make the transfer, or unless we are served with a certified copy of a restraining order of a court of competent jurisdiction, we may be obliged to complete the transfer."

33 See Nicholson v. Morgan, 119 Misc. 309, 196 N.Y.S. 147 (Munic.Ct., New York City, 1922) citing the Uniform Stock Transfer Act, N.Y.Pers.Prop.Law, secs. 162–185.

34 Mohr v. J. C. Penney Co., Inc., 242 App.Div. 385, 275 N.Y.S. 50 (1934). See note 24, *supra*. Hill v. American Telephone & Telegraph Co., 37 N.Y.S.2d 957 (Sup. Ct. 1942).

35 Donaghue v. DiGiorgio Fruit Corp., 225 App.Div. 81, 232 N.Y.S. 178 (1928).

36 *Cf.* Behrends & Elliott, note 16, supra, at page 214. It has been suggested that its very profession of special competence would require the transfer agent to meet a very high standard of care. Customarily, professional agents are extremely cautious in the making of transfers. The bank will exhaust its own investigative facilities on each questionable assignment. If then still uncertain of the propriety of the assignment, before risking either wrongful transfer or final refusal, it will submit the question to its principal for decision.

37 Christy, sec. 281. See 1911 Op.Atty.Gen. (N.Y.) 227 and 1910 Op.Atty.Gen. (N.Y.) 489 as cited in notes under McKinney, N.Y.Tax Law, secs. 270, 272. Further, the transfer agent who keeps the stockholders books may be required by state law to keep them open for inspection. N.Y.Stock Corp.Law, sec. 113, provides a penalty of $50.00 for each day the transfer agent neglects or refuses to keep the books available for the required three hours.

38 Christy, sec. 281. Palmer v. O'Bannon Corp. and Merchants Nat. Bank, 253

be brought, apparently, by a member of the public against the transfer agent for the fraud of its employee,[39] and an assignee of a corporation has recovered losses suffered by reason of the transfer agent's wrongful delay in making delivery of certificates which had been held under an escrow agreement for the corporation.[40]

NEW YORK STOCK CORPORATION LAW.[41]

§ 65. *Form of stock certificates.* The stock of every stock corporation shall be represented by certificates signed by the president or a vice-president and the secretary or an assistant secretary or the treasurer or an assistant treasurer, and sealed with the seal of the corporation. Such seal may be a facsimile, engraved or printed. Where any such certificate is signed by a transfer agent or transfer clerk and by a registrar, the signatures of any such president, vice-president, secretary, assistant secretary, treasurer or assistant treasurer upon such certificate may be facsimiles, engraved or printed. In case any such officer who has signed or whose facsimile signature has been placed upon such certificate shall have ceased to be such before such certificate is issued, it may be issued by the corporation with the same effect as if such officer had not ceased to be such at the date of its issue. Such stock shall be transferable in the manner prescribed in this chapter and in the by-laws. No share shall be transferable until all previous calls thereon shall have been fully paid in.

Every certificate of stock issued by any corporation organized after September thirtieth, nineteen hundred and twenty-three, which is authorized to issue shares of more than one class shall state upon the face or back thereof all of the designations, preferences, privileges and voting powers of the shares of each class which the corporation is authorized to issue, and the restrictions or qualifications thereof, and, if the corporation is authorized to issue in series any class of stock which is preferred as to dividends or assets, the designations, preferences, privileges and voting powers of the shares of each series of such class then authorized and the restrictions or qualifica-

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Mass. 8, 149 N.E. 112 (1925) ("* * * if the bank declined to register the stock in the pledgee's name, the mere declination would not be an act of misfeasance as between itself and the pledgee. It would be at most a neglect of duty for which the corporation alone was responsible." p. 17.); Dunham v. City Trust Co. of New York, 115 App.Div. 584, 101 N.Y.S. 87 (2d Dept. 1906) affirmed without opinion 193 N.Y. 642, 86 N.E. 1123 (1908) (Refusal to transfer does not render the transfer agent liable although the corporation would be); Nicholson v. Morgan, note 24, *supra* (The stock transfer agent owes no affirmative duty to a stockholder. * * * p. 314.)

39 See Citizens & Southern Nat. Bank v. Trust Co. of Georgia and Coca Cola Co., 50 Ga.App. 681, 179 S.E. 278 (1935). Both the transfer agent and the corporation were relieved of liability for this fraud in which the employee forged the signature of the registrar. The certificate bore on its face the usual legend to the effect that it would be valid only when countersigned by the registrar. And see Van Schaick v. Nat. City Bank, note 32, *supra*: in which the transfer agent was relieved because the purchaser had title and not because the transfer agent owed the stockholder no duty.

40 Bertram v. Exchange Trust Co., 4 F.Supp. 392 (D.C.Mass. 1933).

41 The Uniform Stock Transfer Act is in effect in New York: Personal Property Law, art. 6, §§ 162–185.

tions thereof, and the powers of the board of directors in respect to the issuance of subsequent series of the same class.

Every certificate of stock issued by any corporation organized after September thirtieth, nineteen hundred and twenty-three, shall plainly state upon the face thereof the number, kind and class of shares, including series, if any, which it represents.

Every certificate of stock issued by any corporation organized before September thirtieth, nineteen hundred and twenty-three, whose certificate of incorporation is thereafter amended to authorize the issuance from time to time in series of any class of its stock which is preferred as to dividends or assets, shall plainly state on the face or back thereof the designations, preferences, privileges and voting powers of the shares of each series of such class then authorized, and the restrictions or qualifications thereof, and the powers of the board of directors in respect to the issuance of subsequent series of the same class.

§ 66. *Transfer of stock by stockholder indebted to corporation.* If a stockholder shall be indebted to the corporation, the directors may refuse to consent to a transfer of his stock until such indebtedness is paid, provided a copy of this section or the substance thereof is written or printed upon the certificate of stock.

DELAWARE GENERAL CORPORATION LAW.

Sec. 15. *Certificates of Shares:*—Every holder of stock in a corporation shall be entitled to have a certificate, signed by, or in the name of the corporation by, the President or a Vice-President and the Treasurer or an Assistant Treasurer, or the Secretary or an Assistant Secretary of such corporation, certifying the number of shares owned by him in such corporation; provided, however, that, where such certificate is signed (1) by a transfer agent or an assistant transfer agent or (2) by a transfer clerk acting on behalf of such corporation and a registrar, the signature of any such President, Vice-President, Treasurer, Assistant Treasurer, Secretary or Assistant Secretary may be facsimile. In case any officer or officers who shall have signed, or whose facsimile signature or signatures shall have been used on, any such certificate or certificates shall cease to be such officer or officers of such corporation, whether because of death, resignation or otherwise, before such certificate or certificates shall have been delivered by such corporation, such certificate or certificates may nevertheless be adopted by such corporation and be issued and delivered as though the person or persons who signed such certificate or certificates or whose facsimile signature or signatures shall have been used thereon had not ceased to be such officer or officers of such corporation.

Sec. 16. *Stock, Personal Property; How Transferred; When Not Taxed:*—The shares of stock in every corporation shall be deemed personal property and transferable as hereinafter provided, provided, however, that no stock or bonds issued by any corporation organized under this Chapter shall be taxed by this State when the same shall

be owned by non-residents of this State, or by foreign corporations. Whenever any transfer of shares shall be made for collateral security, and not absolutely, it shall be so expressed in the entry of the transfer.

Sec. 16A. *How Title to Certificates and Shares May Be Transferred:*—Title to a certificate and to the shares represented thereby can be transferred only,

(a) By delivery of the certificate indorsed either in blank or to a specified person by the person appearing by the certificate to be the owner of the shares represented thereby or

(b) By delivery of the certificate and a separate document containing a written assignment of the certificate or a power of attorney to sell, assign, or transfer the same or the shares represented thereby, signed by the person appearing by the certificate to be the owner of the shares represented thereby. Such assignment or power of attorney may be either in blank or to a specific person.

The provisions of this section shall be applicable although the charter or articles of incorporation or code of regulations or by-laws of the corporation issuing the certificate and the certificate itself, provide that the shares represented thereby shall be transferable only on the books of the corporation or shall be registered by a registrar or transferred by a transfer agent.

Sec. 16C. *Corporation Not Forbidden to Treat Registered Holder as Owner:*—Nothing in Sec. 16A to Sec. 16X, both inclusive, shall be construed as forbidding a corporation,

(a) To recognize the exclusive right of a person registered on its books as the owner of shares to receive dividends, and to vote as such owner, or

(b) To hold liable for calls and assessments a person registered on its books as the owner of shares.

Sec. 16D. *Title Derived from Certificate Extinguishes Title Derived from a Separate Document:*—The title of a transferee of a certificate under a power of attorney or assignment not written upon the certificate, and the title of any person claiming under such transferee, shall cease and determine if, at any time prior to the surrender of the certificate to the corporation issuing it, another person, for value in good faith, and without notice of the prior transfer, shall purchase and obtain delivery of such certificate with the indorsement of the person appearing by the certificate to be the owner thereof, or shall purchase and obtain delivery of such certificate and the written assignment or power of attorney of such person, though contained in a separate document.

Sec. 16E. *Who May Deliver a Certificate:*—The delivery of a certificate to transfer title in accordance with the provisions of Sec. 16A is effectual, except as provided in Sec. 16G, though made by one having no right of possession and having no authority from the owner of the certificate or from the person purporting to transfer the title.

Sec. 16T. *Definition of Indorsement:*—A certificate is indorsed when an assignment or a power of attorney to sell, assign, or trans-

fer the certificate or the shares represented thereby is written on the certificate and signed by the person appearing by the certificate to be the owner of the shares represented thereby, or when the signature of such person is written without more upon the back of the certificate. In any of such cases a certificate is indorsed though it has not been delivered.

Sec. 16U. *Definition of Person Appearing to Be the Owner of Certificate:*—The person to whom a certificate was originally issued is the person appearing by the certificate to be the owner thereof, and of the shares represented thereby, until and unless he indorses the certificate to another specified person, and thereupon such other specified person is the person appearing by the certificate to be the owner thereof until and unless he also indorses the certificate to another specified person. Subsequent special indorsements may be made with like effect. * * *

KNIGHT v. SHUTZ et al.

Supreme Court of Ohio, 1943. 141 Ohio St. 267, 47 N.E.2d 886.

Action by Paul L. Knight, as executor of the Estate of George F. Knight, deceased, against Margaret C. Shutz and others to enjoin certain corporations from transferring certain shares of stock allegedly obtained by named defendant from the decedent through duress and fraud and from paying dividends to named defendant, and to compel corporations to issue in the name of the executor certificates of stock in lieu of those held by named defendant. From a judgment granting an injunction but finding that court was without authority to compel corporations to transfer stock to plaintiff and pay dividends to him, plaintiff appealed to the Court of Appeals which affirmed trial court's judgment, and the cause is brought to the Supreme Court following allowance of a motion to certify the record.—[Editorial Statement.]

Judgment affirmed.

The Court of Common Pleas of Stark county in cause No. 71087 found that Margaret C. Shutz obtained the assignment and delivery of certain stock certificates by duress and fraud upon one George F. Knight, who had since died. She was ordered to assign and deliver such stock certificates to Paul L. Knight, as executor of the estate of George F. Knight, deceased, and was enjoined from transferring or assigning them or any part thereof to any other person whomsoever.

Upon the failure of Mrs. Shutz to comply with the order of the court she was found guilty of contempt and was imprisoned pending performance. The court also appointed a receiver to take possession of the property and assets and Mrs. Shutz. The receiver was unable to obtain possession of the certificates.

Without surrendering the certificates, Mrs. Shutz was, according to the statements of counsel, released from jail and thereafter sold and delivered one of the certificates in question in the open market.

Mrs. Shutz was again committed to jail and later released without having complied with the order of the court to surrender the certificates.

Thereupon the instant action was brought in the Court of Common Pleas of Stark county by Paul L. Knight as executor of the estate of George F. Knight, deceased, against the several corporations which had issued the certificates which Mrs. Shutz had refused to surrender, to enjoin such corporations and their transfer agents from transferring the shares to any other person and from paying to Margaret C. Shutz any dividends on such stock. It was further sought to compel each of the corporations and their transfer agents to issue in the name of Paul L. Knight, as executor, certificates of stock in lieu of the certificates held by Mrs. Shutz.

After hearing, the trial court entered its decree enjoining the corporations and their transfer agents from assigning and transferring upon their corporate books and records the shares of stock in question and from paying any dividends thereon to Margaret C. Shutz. The court, however, found that it was without authority to issue an order or decree compelling the defendant corporations to transfer upon their books and records such shares of stock to plaintiff or to order such corporations to pay the dividends to plaintiff. The journal entry of the trial court's decree contains the following: "It is therefore ordered, adjudged and decreed that the defendants and each of them are hereby enjoined from transferring upon the books and records of said defendants any of said stock or any part thereof to any other person, firm or corporation, and from paying the dividends accrued thereon or accruing hereafter to any such person, firm or corporation, and the prayer of plaintiff's petition to compel the said defendants to transfer said stocks and shares upon their records, and to pay the plaintiff the dividends accrued thereon and accruing hereafter is hereby denied."

The cause is here following the allowance of a motion to certify the record.

TURNER, JUDGE. The questions presented are whether it was error for the Court of Common Pleas to refuse to order the appellee corporations and their registrars and transfer agents, (1) to transfer the shares of stock in question to appellant, (2) to issue him new certificates therefor, or (3) to pay him the accrued dividends thereon. If the trial court did not so err then the judgment of the Court of Appeals affirming the decree of the trial court should be affirmed.

We shall resist the temptation which this case holds to delve into the extensive bibliography on the subjects of transfer and issuance of corporate shares and stock certificates and the rights to dividends being content to call attention to the fact that some confusion exists by reason of the failure to observe the line of demarcation between those *certificates* of stock, the transfer of which is governed by the Uniform Stock Transfer Act, and *shares* of stock, the transfer of which is not subject to the act. As the act is not effective in all states, and not applicable to all certificates in states where effective,

text and decided cases must be examined to determine whether the case arose under or independently of the act.

Whether the Uniform Stock Transfer Act is, as claimed by some, a mere codification of the prior law or whether it is a code of new law need not disturb us—certain it is that in Ohio the transfers of certificates of corporate stock subject to the act are governed by the act and such statutory enactments are to be read in the same way and interpreted and construed when necessary in the same manner as other statutory enactments. * * *

Under the Uniform Stock Transfer Act, a stock certificate has become something more than mere evidence of title. The title to the certificate and the shares represented thereby can be transferred only by delivery of the certificate duly endorsed or accompanied by a written assignment or power of attorney to assign. Sections 8673-1 and 8673-10, General Code.

Neither attachment nor levy may now be made unless the outstanding certificate be actually seized, or the transfer enjoined. Section 8673-13 and 8673-14, General Code.

While some authorities admit only "quasi-negotiability", [citing cases] * * * the weight of authority holds that Section 5 of the act, Section 8673-5, General Code, gives full negotiability to the certificates of stock covered by the act. * * *

The record in this case fails to disclose that any of the certificates have been lost or destroyed. On the contrary it is agreed among counsel that the certificates are still in existence. Therefore, recourse may not be had to the provisions of Section 8673-17, General Code, which provides that upon satisfactory proof of loss or destruction and upon giving bond the court may order the issuance of a new certificate. See, also, Section 8623-30a, General Code. Attention is called to the following provision of Section 8673-17, General Code: "The issue of a new certificate under an order of the court as provided in this section, shall not relieve the corporation from liability in damages to a person to whom the original certificate has been or shall be transferred for value without notice of the proceedings or of the issuance of the new certificate." See, also, Sections 8623-30a and 8623-12, General Code.

Section 8673-13, General Code, contains the following provision: "* * * Except where a certificate is lost or destroyed, such corporation shall not be compelled to issue a new certificate for the stock until the old certificate is surrendered to it."

Notwithstanding this clear language of Section 8673-13, General Code, appellant seems to assume that in case of an attachment or levy where the certificate has not been surrendered to the corporation but the transfer by the holder has been enjoined, the corporation must issue a new certificate, which, of course, is contrary to the provision of the statute. The case of Elgart v. Mintz, 123 N.J.Eq. 404, 197 A. 747, cited by appellant, does not so hold. See Luks v. Luks, 106 N.J.Eq. 160, 150 A. 346.

Counsel for appellant make the following statement: "Counsel for the appellant herein wishes to state to the court that at the com-

mencement of this brief that neither counsel for plaintiff nor any of the various counsels for the defendants herein have been able to find a case in the United States directly in point nor any case assuming to decide the question in issue." We might add that our independent search has likewise failed.

As stated in the syllabus in Peckinpaugh v. Noble & Co., supra: "12. The uniform stock transfer act * * * is all inclusive and admits of no exception, even including theft or felonious taking from the owner, in protecting the rights of a good-faith purchaser of stock indorsed in blank by the owner." However, some other courts do not agree as to theft. As to theft, see Section 8623-30a, General Code, and 12 Fletcher, Cyclopedia Corporations, 466.

The test of the correctness of the decree below depends upon whether any relief may be afforded appellant under Section 8673-18, General Code, which provides: "In any case not provided for by this act, the rules of law and equity, including the law merchant, and in particular the rules relating to the law of principal and agent, executors, administrators and trustees, and to the effect of fraud, misrepresentation, duress or coercion, mistake, bankruptcy or other invalidating cause, shall govern."

Our inquiry then must be directed to the various provisions of the act to determine whether relief in the instant case is provided for by the act. Attention has been called to the provision of Section 8673-1, General Code, to the effect that title to a certificate and the shares represented thereby can be transferred only by delivery of the certificate.

Section 8673-7, General Code, provides:

"If the indorsement or delivery of a certificate,

"(a) Was procured by fraud or duress, or

"(b) Was made under such mistake as to make the indorsement or delivery inequitable; or

"If the delivery of a certificate was made

"(c) Without authority from the owner, or

"(d) After the owner's death or legal incapacity, the possession of the certificate may be reclaimed and the transfer thereof rescinded, unless:

"(1) The certificate has been transferred to a purchaser for value in good faith without notice of any facts making the transfer wrongful, or

"(2) The injured person has elected to waive the injury, or has been guilty of laches in endeavoring to enforce his rights.

"Any court of appropriate jurisdiction may enforce specifically such right to reclaim the possession of the certificate or to rescind the transfer thereof and, pending litigation, may enjoin the further transfer of the certificate or impound it."

Unless we are willing, which we are not, to acknowledge the futility of the processes of court, the foregoing section provides full and complete relief to appellant which appellant may secure in case No. 71087 in the Court of Common Pleas of Stark county wherein Margaret C. Shutz was found not only to possess the certificates in question but

to have obtained them by fraud and duress. The fact that the trial court in case No. 71087 released Mrs. Shutz from confinement without compliance with the orders of the court is not a sufficient foundation for the instant case. She may still be compelled to surrender the certificates.

In addition to the provisions of the Uniform Stock Transfer Act, the contract relationship between appellee corporations and their stockholders require the surrender of the certificates before transfer is made.

Section 8623-12, General Code, provides that a corporation may adopt a code of regulations. * * *

In Section 8623-31, General Code, is the following provision:

"* * * No restriction of the right to transfer shares and no reservation of lien thereon shall be effective against a transferee of such shares *unless stated on the certificate.*

"Certificates for shares and the shares represented thereby shall be transferable on the books of the corporation *in such manner as the articles or regulations may provide,* not inconsistent with the uniform stock transfer act [Section 8673-1 et seq., General Code] or other statutory provisions existing at the time of transfer." (Italics ours.)

Section 8623-32, General Code, authorizes a corporation to appoint transfer agents and registrars whose duties and liabilities are to be fixed by contract. The several transfer agents and registrars were made defendants below and are here as appellees.

Appellee Eaton Manufacturing Company's exhibit (defendant's exhibit No. 2) contains the resolution appointing appellee the Cleveland Trust Company as transfer agent. Such transfer agent is authorized "to make transfers * * * of certificates for * * * shares * * * now or presently to be outstanding as may be surrendered for transfer properly endorsed" and "Seventh" that "the registrars be and they are hereby authorized and directed to register transfers from time to time of certificates for such capital stock, upon the cancellation of certificates for a like amount of shares of the same class. * * *"

Likewise, the regulations of appellee the Republic Stamping & Enameling Company require "surrender of the duly endorsed certificate or certificates" before transfer.

Printed upon each of the certificates is the following: "Transferable only upon the books of the company by the owner in person or by attorney, upon surrender of this certificate properly assigned." This applies also to the certificates of the appellee Harbauer Company.

Appellant is as much bound by the regulations of the several corporations as was his father through whom he claims. Therefore, if it were to be held that the instant case is one not provided for within the purview of Section 8673-18, General Code, under the rules of law as to contract and of equity and law as to estoppel, appellant would be entitled to no relief in the instant case. * * *

Turning briefly to cases where the Uniform Stock Transfer Act was not involved:

There have been cases in which a court of equity, having all parties before it, has entered a decree which operated upon the title of stock and transferred it to a third person while the certificate was outstanding. Yet no such case, insofar as we have been able to find, has been decided where the Uniform Stock Transfer Act was applicable.

Even in cases where the act did not apply and where a court of equity has ordered such transfer, under the weight of authority the corporation still remains liable to an innocent holder of the outstanding certificate. As stated in 6 Thompson on Corporations, 3d Ed., 298, § 4423: "It seems that a transfer made under a decree of court will not conclude or otherwise affect the rights of a subsequent innocent purchaser where the outstanding certificate was not surrendered; and it has been held that he is not affected by the doctrine of lis pendens."

12 Fletcher, Cyclopedia Corporations, 457, § 5540, contains the following headnote: "If a corporation transfers and issues a new certificate without requiring the production of the outstanding certificate, it becomes liable to a holder in good faith of the outstanding certificate."

In the course of the section (5540, ibid) at page 460 it is said: "The fact that the corporation requires an indemnity bond before it will reissue the stock in no way affects the rights of the holder of the original certificate. Nor does it in any way relieve the corporation from the consequences of its fraudulent act, but is rather a confession that it is violating its obligation not to transfer the stock except on surrender of the certificate." See, also, 2 Cook Corporations, 8th Ed., 1327, § 361.

In the case of Joslyn v. St. Paul Distilling Co., 44 Minn. 183, 46 N.W. 337, decided prior to the enactment of the Uniform Stock Transfer Act, appears the following syllabus: "A stock certificate issued by a corporation having power so to issue, in which it is stated that a designated person is the owner of a certain number of shares of stock transferable only on the books of the association, on the indorsement and surrender of the certificate itself, is a continuing affirmation as to the ownership of the stock, and that the corporation will not transfer the stock upon its books unless the certificate is first surrendered. Such a certificate is an assurance to the commercial world that the shares of stock are the property of the person designated, and that he has the power and right to transfer and sell the stock, until this power and right has been lawfully terminated." See, also, 12 Fletcher, Cyclopedia Corporations, 446, § 5537; 61 A.L.R. 436 note; Keller v. Eureka Brick Mach. Mfg. Co., 43 Mo. App. 84, 11 L.R.A. 472.

While Fletcher at the end of Section 5537, ibid, says: "Of course, if the transferee agrees to indemnify the company against the event of the original certificate turning up in the hands of a bona fide purchaser, it may be compelled to make the transfer," the author is not here considering any provision of the Uniform Stock Transfer Act. Besides the only authority cited for the statement is the case

of Wilson v. Atlantic & St. L. Rd. Co., 2 F. 459, decided by a district court in 1880, long prior to the enactment by any state of the Uniform Stock Transfer Act. That case involved the demand by a trustee in bankruptcy followed by the tendering of a bond of sufficient indemnity.

An instructive case in this connection, and one in which the court did not find it necessary to come to a conclusion upon the question whether the Uniform Stock Transfer Act did or did not govern the decision, is Parkhurst et al., Ex'rs. v. Almy, 222 Mass. 27, 109 N.E. 733, 734. In that case it was sought to compel a corporation to issue certificates of corporate stock in lieu of the certificates theretofore issued in the name of a debtor prior to the passage of the Uniform Stock Transfer Act. It was suggested that the creditor in that case might procure an equal number of shares and hypothecate them for the protection of the corporation and the possible purchaser of the debtor's certificates. In the course of the opinion it was said:

"A corporation has no right to make an overissue of its capital stock, and a court has no power to give it a right to do so. A decree in the form set forth in the report seems to undertake to proceed upon that basis [that it has such a right] in providing that upon the issue of certificates to a special master in lieu of the certificates now standing in the name of William F. Almy 'such corporations shall be discharged and released from all liability by reason of the outstanding certificates in the name of said William F. Almy,' provided the plaintiffs give to each of the corporations a bond 'conditioned to hold such corporations harmless from all claims of any person or corporation establishing by and through the outstanding certificates in the name of William F. Almy a title legally and equitably paramount to the title obtained by the purchaser of the certificates sold by the special master hereunder.'

"If it were established that Almy was now the owner of the shares which stand on the books of the corporation in his name, and also that no one could become entitled to them hereafter, there would be no objection to the clause in the decree which provides that upon the issue of certificates to the special master in lieu of the certificates now outstanding in the name of William F. Almy, 'such corporations shall be discharged and released from all liability by reason of the outstanding certificates in the name of said William F. Almy.' But neither one of these two propositions is established. If the certificates for these shares have been transferred already to a bona fide purchaser for value without notice the title to the shares is in the transferee of these certificates. Athol Savings Bank v. Bennett, 203 Mass. 480, 89 N.E. 632; Clews v. Friedman, 182 Mass. 555, 66 N.E. 201. Even if the title to these shares is now in Almy it would pass from him if certificates for these shares are hereafter transferred by him to a bona fide purchaser for value without notice. Athol Savings Bank v. Bennett and Clews v. Friedman, supra.

"As we construe the decree it (in effect) takes away these shares from the true owners of them (in case the certificates for them already have been or shall be hereafter transferred by Almy to a bona

fide purchaser for value without notice) and it substitutes for the shares rights of action against the corporations. But that is something which the court has no power to do. A court has no power to take away from the owner his property in shares in the capital stock of a corporation and substitute for that property a right of action against the corporation. It has no more power to take away shares belonging to a bona fide purchaser of Almy's certificates on substituting therefor a right of action against the corporation (even although the right of action is made good by a bond with sufficient sureties) than it has to take away from the owner of them his property in other shares in the capital stock of a corporation."

As counsel for appellant frankly admit that they have been unable to find any case directly in point, it will be unnecessary to discuss all of the cases cited in their brief. * * *

The case of Columbia Brewing Co. v. Miller, 5 Cir., 281 F. 289, arose under the Trading with the Enemy Act of November 4, 1918, requiring corporations under prescribed conditions to cancel outstanding shares of stock and in lieu thereof to issue certificates to the alien property custodian. However, it was also said in that case that: "* * * but such transfer does not deprive any nonenemy claimant of vested rights, which may be established by proceeding under section 9 of the act, as amended [50 U.S.C.A.Appendix § 9]."

Appellant's quotation from 6 Thompson Corporations, 298, to the effect that: "* * * a court of equity, having all proper parties before it, may enter a decree that will operate upon the title of the stock and transfer it to a third person, while the certificate is outstanding" is preceded in the text by the words "On the other hand, it has been held that." This exception to the general rule stated earlier in the same section is based upon the case of Sprague v. Cocheco Mfg. Co., 22 Fed.Cas. page 960, No. 13,249, 10 Blatch. 173, decided by United States District Court in 1872. It is also cited by appellant. The decision involved a Massachusetts trusteeship of the stock of a Massachusetts corporation. The decision is not only contrary to the Uniform Stock Transfer Act but to the modern Massachusetts cases.

The question as to the right of appellant to dividends has not been argued, though assigned as error. The right to dividends follows the right to have the stock transferred. Sections 8623-33a and 8673-3, General Code.

We find no error in the judgment of the Court of Appeals and therefore such judgment should be and hereby is affirmed.

Judgment affirmed.

PRICE OF ISSUE

THE RULE OF EQUITABLE CONTRIBUTION

Throughout the history of business corporation, an evil has steadily appeared, with which growing rules of law have had to cope. This is the attempt to secure shares of stock without making a contribu-

tion to the corporate assets, or by making a contribution less than that exacted from other shareholders. The holder of such "cheap" stock in effect gets a free ride at the expense of full paying subscribers.

In respect of stock having par value, the law attempted to prevent this by requiring that such stock, to be validly issued, must be paid for at par value, in money or moneys' worth. The sanction, or penalty, was that the recipient of stock who had not paid par value, might be required to pay the full amount, at the insistence of creditors if the corporation became insolvent, or possibly at the insistence of other shareholders.

But this rule could be evaded by either of two devices: issue of stock having a very low par value, but sold at a price above par. Many corporations are organized with the common stock having a par value of $1.00 per share, though the price to subscribers on original issue is many times the nominal par value. Thus, one group could purchase the stock at $1.00 per share while others paid considerably more. The other device was to issue stock without nominal or par value; and in respect of such stock no minimum or standard contribution is required. Yet in both cases, when stock is issued, the effect of permitting one subscriber to buy at a low price while another pays a high price, in effect enriches the low price buyer at the expense of the high price buyer.

To prevent this inequity, Judges early worked out (without help of the Statutes) a rule giving shareholders the right to buy new shares of stock of the corporation *pro rata* in proportion to their holdings. This was called "preemptive right" though in fact it was more in the nature of an automatic rule of thumb remedy.

Clearly this does not exhaust the power of a Court of Equity. There appears to be a policy requiring purchasers of stock on original issue to make an equitable contribution to the assets of the corporation, since all are to share in its earnings and assets. Sale of stock by the corporation to favor its purchasers at unduly low prices, working a wrong on other shareholders could, it would appear, be enjoined; or, in case such sale had been completed, the stock if still in the hands of a party to the transaction could be cancelled and the transaction rescinded. The various remedies thus are grouped about a single equitable principle which has been called "The Rule of Equitable Contribution".

(a) Par Value Stock.

DELAWARE GENERAL CORPORATION LAW

§ 14. * * * Any corporation may issue the whole or any part of its shares as partly paid and subject to call for the remainder of the consideration to be paid therefor. Upon the face or back of the certificates issued to represent any such partly paid shares the total amount of the consideration to be paid therefor and the amount paid

thereon shall be specified. The corporation may declare and pay dividends upon any such shares upon the basis of the percentage of the consideration actually paid thereon. * * *

WELTON v. SAFFERY.

House of Lords. [1897] A.C. 299.

The following statement of the facts is in substance taken from the judgment of Lord Davey.

The Railway Time Tables Publishing Company, Limited, was registered in January, 1886, under the Companies Acts as a company limited by shares. The memorandum of association contained the following clause:

"The capital of the company is £30,000 divided into 6,000 shares of £5 each, with power to increase the capital, and to issue any shares in the original or in any new capital as preferential, or guaranteed, or deferred shares." No articles were registered with the memorandum. The regulations adopted for the conduct of the affairs of the company were, therefore, in the first instance, those contained in Table A in the first schedule to the Companies Act 1862.

All the original shares (except the ten subscribed for in the memorandum) were issued to the vendor as fully paid up under a registered contract, and it was not disputed that they were rightly so issued. They were dealt with, and large numbers of them were in the hands of the general public.

By a special resolution passed and confirmed on May 25 and June 11, 1886, the capital was increased to £40,000 by the creation of 2,000 additional shares of £5 each. Of these shares 600 were issued and paid up in cash, 500 were issued as "bonus shares," and the remaining 900 were issued as "discount shares." By a second resolution passed and confirmed on the same dates, new articles of association were adopted in the place of Table A. The material articles, for the present purpose, are those Numbered 4, 41, 42 and 140.

4. "The shares shall be under the control of the directors, who may allot or otherwise dispose of the same to such persons on such terms and conditions, and at such times, as the directors think fit, and either at a discount, premium or otherwise."

41. "The company may from time to time increase the capital by the creation of new shares of such amount as may be deemed expedient."

42. "The new shares shall be issued upon such terms and conditions and with such rights and privileges annexed thereto as the directors shall determine, and in particular such shares may be issued with a preferential or qualified right to dividends, and in the distribution of the assets of the company, and with a special, or without any, right of voting."

140. "If the company shall be wound up and the surplus assets shall be insufficient to repay the whole of the paid-up capital, such surplus assets shall be distributed so that as nearly as may be the

losses shall be borne by the members in proportion to the capital paid up, or which ought to have been paid up, on the shares held by them respectively at the commencement of the winding-up. But this clause is to be without prejudice to the rights of holders of shares issued upon special conditions."

The bonus shares were issued to subscribers for debentures in the company as fully paid up, without any consideration in money or money's worth except the subscription for debentures, two shares of £5 each being issued to each subscriber for a £10 debenture. The discount shares, after being offered to the existing shareholders at the price of £1 per £5 share, were issued to Mr. Henry Hoare, as fully paid up, in consideration of the payment of 10/- per share, or (in other words) at a discount of £4. 10. 0. per share.

The appellant was the holder of 215 bonus shares, which he acquired for a nominal consideration from Hoare. The appellant had been placed on the list of contributories for the whole of these 215 shares as wholly unpaid.

The appellant was also the holder of 4,460 discount shares which he also acquired from Hoare for a nominal consideration. The appellant had been placed on the list of contributories as the holder of 4,460 shares upon which £4. 10s. remained unpaid.

The appellant was also the holder of 1,680 preference shares. The allotment of these shares was part of the consideration for the extinction of a debt of £13,000 odd, due from the company to Hoare. By an order of June 14, 1893, these shares were held to be as to 1,112 fully paid, as to 567 wholly unpaid, and as to one paid to the extent of £2. 10s.

By an extraordinary resolution, dated March 25, 1892, it was resolved that the company be wound up voluntarily. By an order of April 13, 1892, the voluntary winding-up was continued subject to the supervision of the Court. The respondent was the liquidator of the company.

Calls were made in the winding-up for the payment of the debts of the company and the costs of winding up. No question now arose as to these. The respondent having taken out a summons for a final call upon the bonus, discount, and preference shares to enable the liquidator to adjust the rights of the contributories inter se, Kekewich, J. on August 7, 1894, held that the appellant was responsible for the amount remaining unpaid on his shares not only for the payment of the debts and costs of the winding up, but also for the adjustment of the rights of contributories inter se, and ordered accordingly.

This order was affirmed by the Court of Appeal. From these decisions the present appeal was brought. * * *

1897. April 8. LORD HALSBURY L. C. (after stating the facts): My Lords, in respect of the liability to pay up the shares so far as it is necessary to satisfy creditors and the cost of winding-up, I believe no doubt exists in the minds of any of your Lordships. Since the Ooregum Case (1892) A.C. 125, in this House it would be impossible to contend that that question is not covered by authority.

But it is said that, where the only object in making a call is to settle the rights of the shareholders inter se, the law laid down in the Ooregum Case does not conclude the question.

My Lords, I am unable to accede to that view. I think the Legislature, in permitting the existence of a company limited by shares and with limited liability, created a machinery which makes it impossible by any expedient, either by company or shareholder, to act otherwise than in pursuance of the provisions of the statute. Whether for the purpose of settling the rights inter se, or for the purpose of satisfying creditors, it appears to me that the statute enforces upon company and shareholder alike conformity to the rule laid down, that a share for a fixed amount shall make the person agreeing to take that share liable for that amount. I think that is the decision of the Ooregum Case, and though I am aware that a different view has been suggested where the question is not the payment of the debts of the company, but the settlement of the rights of the shareholders inter se, I am unable to see how this artificial creature, limited within its sphere of action by the statute under which it is created, can do anything contrary to the provisions of the statute. It is not a question for what purpose it is done. Dealing with it as I think it must be dealt with, as an artificial creation, it can only act as a company or as shareholder in either of those characters within the fetters created by the Act of Parliament.

It is said, and I think justly said, that people have been invited to take shares under an article of association which expressly provided that shares might be issued at a discount. It is, I think hard for persons who have relied upon that assurance to find out that the article which authorized the issue of the shares at a discount was ultra vires of the company, because it is in conflict with the memorandum of association which by the statute itself must determine the rights in that respect; but not the less on that account must one insist that the statute must be obeyed. If one were to suppose that the whole 6000 original shareholders or persons who became shareholders by purchase in the market were to have agreed that these shares would only be regarded as having 10/ - due upon them, each of them might perhaps against himself establish some contract by which the person agreeing with him in his individual capacity might have rights, but it would not be in his capacity as shareholder—it would be in his capacity as individual. The liquidator can only recognise shareholders, and their relation to the company of which they are shareholders must be regulated by the Act of Parliament.

The right to have a call made where it is necessary to adjust the rights between the different shareholders themselves appears to me not less imperative than if only the creditors were in question. The supposed bar to such a proceeding is the agreement not to ask more than 10/ - per share upon the discount shares; but the whole question goes back to the same point. If the Legislature has prohibited that, there is no such agreement. The directors have no power to make such an article. The company *quâ* company have no power to agree to such an article, and those who have taken shares and paid for them

in pursuance of the Act of Parliament, I think, have a right to have the shares paid up which the Act of Parliament has enacted shall be liable to that payment.

In truth, though in form reserved by the discussion in the Ooregum Case, I think the Ooregum Case does decide the question now in debate, and whether they were bonus shares upon which nothing was paid, or discount shares upon which 10/ - only was paid, the holders of those shares are, in my judgment, liable to make good for any company purpose the amount of the money which, upon the face of the share, they undertake to pay.

My Lords, I confess it seems to me, however hardly it may operate upon individuals, to be a just and right thing that those who have completely discharged their statutory obligation should have a right to call upon the other shareholders to do as they have done and pay what is due upon the shares.

No question as to the preference shares is really in debate.

For these reasons I am of opinion that the order appealed from ought to be affirmed and this appeal dismissed with costs, and I move your Lordships accordingly. * * *

NOTE

"(In the case of) watered stock * * * the corporation not only issues the shares below par, but issues it under an agreement between itself and the subscribers that the stock shall be considered full paid. * * * Where stock is thus watered, two questions arise: First, is the corporation bound by its agreement to consider the stock full paid, or may it later denounce the agreement as void, and proceed to assess? Second, even if the corporation is held to have waived its claims, does such a waiver hold against creditors?" Bonbright, Shareholders' Defenses Against Liability to Creditors On Watered Stock, 1925, 25 Col. L.Rev. 408, 410. See, also, Cook, "Watered Stock"—Commissions—"Blue Sky Laws" —Stock Without Par Value, 1921, 19 Mich.L.Rev. 583.

SCOVILL v. THAYER.[43]

Supreme Court of the United States, 1881. 105 U.S. 143, 26 L.Ed. 968.

MR. JUSTICE WOODS delivered the opinion of the court.

* * * The next question for our consideration is, whether the defendant in error is entitled to offset against his liability to pay the sum due on his valid stock, the money paid on his void stock.

It is a general rule, that a holder of claims against an insolvent corporation cannot set them off against his liability to assessment on his stock in the corporation, in a suit by an assignee in bankruptcy. Sawyer v. Hoag, 17 Wall. 610, 84 U.S., 21 L.Ed. 731; Sanger v. Upton, 91 U.S. 56, 23 L.Ed. 220; Scammon v. Kimball, 92 U.S. 362, 23 L.Ed. 483; Morgan County v. Allen, 103 U.S. 498, 26 L. Ed. 498.

The ground upon which this rule stands, is thus stated by Mr. Justice Miller in Sawyer v. Hoag: "The debt which the appellant

43 Statement of facts and that part of the opinion dealing with the increase of capital stock appears *supra*, p. 228.

owed for his stock was a trust fund devoted to the payment of all the creditors of the company. As soon as the company became insolvent, and this fact became known to the appellant, the right of set-off for an ordinary debt to its full amount ceased. It became a fund belonging in equity to all its creditors, and could not be appropriated by the debtor to the exclusive payment of his own claim."

The defendant seeks to avoid the application of this rule to his case, on the ground that the real capital of the company was only $200,000, and this constituted the trust fund for the security of the debts of the company; that all the money that had been paid in as capital stock had been paid into that fund, and that the party paying any money to that fund, was entitled to credit upon his dues thereto.

We cannot assent to this view. The defendant in error was as much bound to know the limits of the charter of the Company in which he was a stockholder, as the public, or creditors of the Company. He knew, therefore, that all stock issued beyond the limit fixed by the charter was absolutely void. When he paid in his money on the void stock, he knew that he was not paying it on the valid stock, and he is presumed to have known that it was not a good payment on the valid stock. The Company had no right to apply it on the valid stock, without his direction. He never directed such application, and it remained in the possession of the Company until the rights of the assignees in bankruptcy attached. To say that it was a contribution to the trust fund, devoted to the payment of the creditors of the Company, is an entire misapprehension. It could not be such contribution, unless it were a payment on the stock of the Company, and this we have seen was not the case. No call had been made by the Company for payment on the valid stock, to which the amounts paid on the void stock could be said to apply. No call could have been made by the Company under its agreement with the stockholders, unless to pay its creditors, and it does not appear that when the payments were made the Company had any creditors. It was a voluntary payment for the benefit of the Company, and tended to increase the value of the authorized stock. In that way the stockholder got the benefit of it. There is no rule of law or equity which entitled him, in a contest between himself and a creditor of the Company, either to receive a credit for it on his unpaid stock, or to have it repaid to him pro rata out of the assets of the Company. We are of opinion, therefore, that it could not be offset against the money due on the valid stock held by him.

We are next to consider whether, upon the facts as disclosed by the record, the defense of the Statute of Limitations should have been sustained. The precise question with which we have to deal is, when would this action at law, brought by the assignees of the bankrupt Company against a stockholder to recover a part of the balance due on his stock, be barred by the statute?

This will depend on the answer to the question, when did the cause of action accrue to the assignees? In other words, when could they have commenced this action against this defendant to recover the

amount due on his stock? Wilcox v. Plummer, 4 Pet. 172, 7 L.Ed. 821; Amy v. Dubuque, 98 U.S. 470, 25 L.Ed. 228.

The stock held by the defendant in error was evidenced by certificates of full paid shares. It is conceded to have been the contract between him and the Company that he should never be called upon to pay any further assessments upon it. The same contract was made with all the other shareholders, and the fact was known to all. As between them and the Company this was a perfectly valid agreement. It was not forbidden by the charter of the Company or by any law or public policy, and as between the Company and its stockholders was just as binding as if it had been expressly authorized by the charter.

If the Company, for the purpose of increasing its business, had called upon the stockholders to pay up that part of their stock which had been satisfied "by discount," according to their contract the stockholders could have successfully resisted such a demand. No suit could have been maintained by the Company to collect the unpaid stock for such a purpose. The shares were issued as full paid, on a fair understanding, and that bound the Company.

In fact, it has been held in recent English cases that not only is the Company, but its creditors also, bound by such a contract. Waterhouse v. Jamieson, L.R., 2 H.L., sec. 29; Currie's case, 3 De F., J. & S., 367; Carling, H. & W. cases, L.R., 1 Ch.Div., 115.

But the doctrine of this court is, that such a contract, though binding on the Company, is a fraud in law on its creditors, which they could set aside; that when their rights intervene, and to satisfy their claims, the stockholders could be required to pay their stock in full. Sawyer v. Hoag, 17 Wall. 610, 84 U.S., 21 L.Ed. 731; New Albany v. Burke, 11 Wall. 96, 78 U.S., 20 L.Ed. 155; Burke v. Smith, 16 Wall. 390, 83 U.S., 21 L.Ed. 361.

The reason is, that the stock subscribed is considered in equity as a trust fund for the payment of creditors.[43] Wood v. Dummer, 3 Mason 308, Fed.Cas.No.17944; Mumma v. Potomac Co., 8 Pet. 286, 8 L.Ed. 945; Ogilvie v. Knox Ins. Co., 22 How. 387, 63 U.S., 16 L. Ed. 351; Sawyer v. Hoag, ubi supra. It is so held out to the public, who have no means of knowing the private contracts made between the corporation and its stockholders. The creditor has, therefore, the right to presume that the stock subscribed has been or will be paid up, and if it is not, a court of equity will at his instance, require it to be paid.

In this case, the managers and agents of the bankrupt Company had in effect represented to the public that all its capital stock had been subscribed for and had been or would be paid in full. Con-

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[43] An excellent discussion and severe criticism of the trust fund theory appears in an article by Hunt, The Trust Fund Theory, 1902, 12 Yale L.J. 63. See, also, Barrows, The Equitable Liability of Stockholders: The Grounds Upon Which It Rests, 1903, 13 Yale L.J. 66; Hale, A Field for Corporate Law Revision: Stockholders' Liability to Creditors, 1917, 12 Ill.L.Rev. 6; Wickersham, The Capital of A Corporation, 1909, 22 Harv.L.Rev. 319, 329–336; Notes, 1908, 8 Col.L.Rev. 303, 1924, 24 Col.L.Rev. 772, 1907, 20 Harv.L.Rev. 401, 1912, 25 Harv.L.Rev. 278, 1908, 56 U. of Pa.L.Rev. 57.

sidered, therefore, in the view of a court of equity, the contract between the Company and its stockholders was this, namely, that the stockholders should pay, say, for example, $20 per share on their stock and no more, unless it became necessary to pay more to satisfy the creditors of the Company, and when the necessity arose, and the amount required was ascertained, then to make such additional payment on the stock as the satisfaction of the claims of creditors required. * * *

But in the present case, as we have seen, as between the Company and its stockholders there was no obligation on the part of the latter to pay the residue of their stock, unless it became necessary to satisfy creditors. We think, therefore, we are safe in saying that the statute did not begin to run in favor of the stockholders until at the very least the necessity for the payment had been ascertained, and an authorized demand of payment made. * * *

For the error in holding that the action was barred, the judgment of the Circuit Court must be reversed and the cause remanded, with directions to award a new trial.

NOTE

"If stockholders are indebted to the corporation for unpaid installments on stock this debt is an asset of the corporation which, in case it becomes insolvent, any creditor may enforce for the purpose of satisfying his claim. * * * But where stock is sold at a discount or is given away as full-paid, it is very clear that the stockholder owes the corporation nothing. As between the corporation and the stockholder the arrangement by which the stock is issued as full-paid stock is entirely valid. Upon what ground is it then held that the arrangement, although valid against the company, will be ineffectual against the creditor? * * * Most courts recognize that there is such a liability upon the original holders of bonus or watered stock or their transferees with notice. * * * This liability has been accounted for on various theories; first, upon the trust fund theory * * * second, the fraud theory, the presumed reliance of the creditor upon the issued capital stock of the company; third, the co-debtor theory, to the effect that the stockholders are in reality co-debtors up to the limit set by the par value; and fourth, the prescribed obligation theory, that an obligation to contribute an amount equal to the par value is imposed by operation of law as an incident of acquiring membership in a corporation. The trust fund theory is the one most commonly advanced. * * * The capital of a corporation may perhaps be regarded as a trust fund in the sense that it cannot be diverted or distributed among the shareholders without provision being first made for the full payment of corporate debts. * * *" Ballantine, Stockholders' Liability in Minnesota, 1923, 7 Minn.L.Rev. 79, 82–93.[44]

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[44] On shareholders' liability for the par value of bonus and discount shares see, Christensen v. Eno, 106 N.Y. 97, 12 N.E. 648, 60 Am.Rep. 429, 1887; Ballantine, Stockholders' Liability in Minnesota, 1923, 7 Minn.L.Rev. 79, 108–111; Notes, 1924, 24 Col.L.Rev. 772, 1916, 29 Harv.L.Rev. 854, 1925, 38 Harv.L.Rev. 1112, 1926, 39 Harv.L.Rev. 757.

See, also, Go, The Legal Aspects of Bonus Stock in a Corporation, 1937, 17 Phil. L.J. 85.

HANDLEY v. STUTZ.

Supreme Court of the United States, 1891.
139 U.S. 417, 11 S.Ct. 530, 35 L.Ed. 227.

[The Clifton Coal Company was incorporated in 1883 in Kentucky, with a capital stock of $120,000 and power to increase same to $200,000 by a majority vote of its shareholders. In 1886 the company, wishing to expand, issued $50,000 in bonds. Finding that it could not sell the bonds, the company determined to issue capital stock to the amount authorized in the certificate of incorporation and to offer, as a further inducement, $1,000 in stock to each purchaser of a $1,000 bond. The bonds were subscribed for, paid up and delivered with stock certificates reciting on their face that they were "paid-up" and "non-assessable". Shares amounting to $30,000 were not needed as premiums in the bond issue; these were distributed *pro rata* as dividends to the old shareholders.

In 1887, the company went into receivership. In 1889, this bill was filed by judgment creditors of the corporation against the company and the holders of the bonus shares to compel the latter to pay for the stock and to recover the amounts of the judgments. Plaintiffs alleged that the increase and amount due on the stock was a trust fund for their benefit which they were entitled to have the court administer to satisfy their debts. The lower court held that defendants were liable to those creditors whose debts had originated after the increase of the capital stock. Defendants appeal.]

MR. JUSTICE BROWN delivered the opinion of the court. * * * Somewhat different considerations apply to those who subscribed for the bonds of the company with the understanding that they were to receive an amount of stock equal to the bonds as an additional inducement to their subscription. The facts connected with this transaction are substantially as follows: Some three years after the company was organized it became apparent that the enterprise, as originally contemplated, namely, the mining and selling of coal for steam and domestic purposes, was not likely to be a success, owing to the inferior character of the product; and the only hope of the company lay in the manufacture of the coal into an iron-making coke, that is, a coke containing a percentage of sulphur low enough to admit of the manufacture of merchantable pig-iron. To embark in this, however, money was needed, and, as the stock of the company was not worth more than 50 cents on the dollar, it was evident this could not be effected simply by the issue of new stock. It was proposed at the meeting in March that money should be raised by the issue of $50,000 of bonds, with which to add the requisite structures to the plant. But it was soon evident that the bonds could not be negotiated without the stock, and, acting upon the suggestion of a Nashville banker, it was resolved at the meeting in May that the stock should be increased 800 shares, 500 of which should be turned over to the subscribers to the bonds as a bonus or an additional consideration. The evidence is uncontradicted that the bonds could not

have been negotiated without the stock; that they were both sold as a whole; that the transaction was in good faith; and, considering the risk that was taken by the subscribers, the price paid for the stock and bonds was fair and reasonable. The directors appear to have done all in their power to obtain the best possible terms, and there is no imputation of unfair dealing on the part of any one connected with the transaction. At that time the mines and property of the company were in good condition, and the prospects of success were fair.

The case, then, resolves itself into the question whether an active corporation, or, as it is called in some cases, a "going concern," finding its original capital impaired by loss or misfortune, may not, for the purpose of recuperating itself and providing new conditions for the successful prosecution of its business, issue new stock, put it upon the market, and sell it for the best price that can be obtained. The question has never been directly raised before in this court, and we are not, consequently, embarrassed by any previous decisions on the point. In the Upton Cases, arising out of the failure of the Great Western Insurance Company; in Hatch v. Dana, 101 U.S. 205, 25 L. Ed. 885; and in Hawkins v. Glenn, 131 U.S. 319, 9 S.Ct. 739, 33 L. Ed. 184,—the defendants were either original subscribers to the increased stock, at a price far below its par value, or transferees of such subscribers; and the stock was issued, not, as in this case, to purchase property or raise money to add to the plant, and facilitate the operations of the company, but simply to increase its original stock in order to carry on a larger business, and the stock thus issued was treated as if it formed a part of the original capital. In County of Morgan v. Allen, 103 U.S. 498, 26 L.Ed. 498, the same principle was applied to a subscription by a county to the capital stock of a railroad company, for which it had issued its bonds, although such bonds had been surrendered to the county with the consent of certain of its creditors.

To say that a corporation may not, under the circumstances above indicated, put its stock upon the market, and sell it to the highest bidder, is practically to declare that a corporation can never increase its capital by a sale of shares, if the original stock has fallen below par. The wholesome doctrine, so many times enforced by this court, that the capital stock of an insolvent corporation is a trust fund for the payment of its debts, rests upon the idea that the creditors have a right to rely upon the fact that the subscribers to such stock have put into the treasury of the corporation, in some form, the amount represented by it; but it does not follow that every creditor has a right to trace each share of stock issued by such corporation, and inquire whether its holder, or the person of whom he purchased, has paid its par value for it. It frequently happens that corporations, as well as individuals, find it necessary to increase their capital in order to raise money to prosecute their business successfully, and one of the most frequent methods resorted to is that of issuing new shares of stock and putting them upon the market for the best price that can be obtained; and, so long as the transaction is bona fide,

and not a mere cover for "watering" the stock, and the consideration obtained represents the actual value of such stock, the courts have shown no disposition to disturb it. Of course no one would take stock so issued at a greater price than the original stock could be purchased for, and hence the ability to negotiate the stock and to raise the money must depend upon the fact whether the purchaser shall or shall not be called upon to respond for its par value. While, as before observed, the precise question has never been raised in this court, there are numerous decisions to the effect that the general rule that holders of stock, in favor of creditors, must respond for its par value, is subject to exceptions where the transaction is not a mere cover for an illegal increase. * * *

The liability of a subscriber for the par value of increased stock taken by him may depend somewhat upon the circumstances under which, and the purposes for which, such increase was made. If it be merely for the purpose of adding to the original capital stock of the corporation, and enabling it to do a larger and more profitable business, such subscriber would stand practically upon the same basis as a subscriber to the original capital. But we think that an active corporation may, for the purpose of paying its debts, and obtaining money for the successful prosecution of its business, issue its stock, and dispose of it for the best price that can be obtained. Stein v. Howard, 65 Cal. 616, 4 P. 662. As the company in this case found it impossible to negotiate its bonds at par without the stock, and as the stock was issued for the purpose of enhancing the value of the bonds, and was taken by the subscribers to the bonds at a price fairly representing the value of both stock and bonds, we think the transaction should be sustained, and that the defendants cannot be called upon to respond for the par value of such stock, as if they had subscribed to the original stock of the company. Our conclusion upon this branch of the case disposes of it as to those who were held liable by virtue of their subscription to the bonds. * * *

It results that the decree of the court below must be reversed, and the cause remanded for further proceedings in conformity with this opinion.

FULLER, C. J. (dissenting). I dissent from the conclusion of the court in respect of the stock received by the subscribers to the bonds. That stock was not paid for in money or money's worth, or issued in payment of debts due from the company, or purchased at sale upon the market. It was a mere bonus, thrown in with the bonds as furnishing the inducement to the bond subscription, of larger control over the corporation, and of possible gain without expenditure. Becoming secured creditors through the bonds, the subscribers increased their power through the stock. In my view, there was no actual payment for the stock, and to treat it as paid up is to sanction an arrangement to relieve those who would reap the benefit derived from the possession of the stock in the event of the success from liability for the consequences in the event of the failure of the enterprise.

When the capital stock of a corporation has become impaired, or the business in which it has engaged has proven so unremunerative as to

call for a change, creditors at large may well demand that experiments at rehabilitation should not be conducted at their risk. My Brother LAMAR concurs with me in this dissent.[45]

HARMAN v. HIMES.

United States Court of Appeals for the District of Columbia, 1935.
77 F.2d 375, 64 App.D.C. 252.

Appeal from the Supreme Court of the District of Columbia.

Action by Robert G. Harman, receiver of the Lincoln Hotel Corporation, against Joseph H. Himes. From an adverse decree, plaintiff appeals.

Reversed.

GRONER, ASSOCIATE JUSTICE. Lincoln Hotel Corporation was chartered October 27, 1922, under the laws of Delaware. The articles of incorporation gave it wide powers in relation to dealing in real estate, but concededly the purpose of its incorporation was to build and operate a hotel in the city of Washington. Its authorized capital stock was limited to $1,000,000 until on December 27, 1922, it obtained an amendment to its charter, increasing it to $1,500,000, to be represented by 5,000 shares of preferred and 10,000 shares of common stock, all of the par value of $100 per share. Three months after its incorporation, and one month after the amendment of its charter, namely on January 27, 1923, appellee, Joseph H. Himes, entered into a written agreement with the corporation, in which it agreed to sell and deliver to him and he agreed to purchase 700 shares of preferred and 700 shares of common stock of the corporation for the sum of $50,000. The contract provided that the money should be used for the purpose of acquiring title to certain property in Washington city on which the corporation had options and on which it intended to build its hotel, but that $10,000 might be used for the purposes of organization expenses and promotion and the sale of the remaining preferred and common stock. The corporation agreed to acquire promptly title to the lot and thereafter, out of the first proceeds from the sale of preferred stock, to acquire from Himes at par the $70,000 of preferred stock purchased by him or so much thereof as he might desire to sell. There was another provision looking to the creation of a voting trust by deposit of enough of the company's common stock, together with Himes' 700 shares, to provide control, the voting trust to terminate when the repurchase from Himes of the preferred stock was made.

We gather from the record that the corporation did purchase the lot of land, using the money paid in by Himes as the cash payment, and securing the balance by deeds of trust. What happened thereafter is not so clear, but on the 11th of April, 1928, more than five years after the events just narrated, and at the instance of creditors, ap-

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45 Bonbright, Shareholders' Defenses Against Liability to Creditors, 1925, 25 Col.L.Rev. 408, 429; Wickersham, The Capital of a Corporation, 1909, 22 Harv.L.Rev. 319, 330–322; Note, 1908, 8 Col.L.Rev. 303, 304; 1919, 3 Minn.L.Rev. 281.

pellant, Harman, was appointed receiver by a Delaware court, with the customary powers of receivers in such cases. Harman qualified, gave bond, and took possession of the books of the corporation, but apparently nothing else. Thereafter in the same proceeding an order was passed authorizing creditors to prove their claims against the corporation. This was done and claims were proved and allowed to an amount in excess of $95,000. On April 1, 1931, the receiver, in order to pay the debts of the corporation, petitioned the court to levy an assessment on stockholders for the amount of their respective unpaid stock subscriptions. There was a hearing on this petition, and a decree passed on the 20th of January, 1932, finding there were no funds or property of the corporation with which to pay its debts except the money due from those of its stockholders who had not paid in full for their shares. The amount of debts due by the company was determined, and Himes was declared to be in default to the company to the amount of $90,000 (the difference between the par value of the 1,400 shares of preferred and common stock purchased by him and the payment of $50,000 made by him).

The action below was instituted by the receiver against Himes to recover this $90,000, and was tried to a jury, but after all the evidence had been introduced the trial court gave binding instructions in favor of Himes and thereafter entered judgment against the receiver; and this appeal followed.

The question here is whether, under the statutes of Delaware as they were at the time of making the contract, every holder of corporate stock issued to him for less than par is liable, in case of insolvency, to corporate creditors for the difference between the amount paid and the par of stock so held; stated differently, whether a Delaware corporation has power, under the Constitution and laws of that state, to issue and dispose of par value stock at less than par.

We conclude there can be no doubt that in reaching an answer to this question we are controlled by the decisions of the highest court of Delaware construing its Constitution and laws in relation to a business corporation chartered under its laws. Royal Arcanum v. Green, 237 U.S. 531, 544, 35 S.Ct. 724, 59 L.Ed. 1089, L.R.A.1916A, 771. That case involved a Massachusetts corporation. A suit was brought against it in New York to have declared invalid an amendment to the corporation's Constitution and by-laws increasing the assessment on members. The corporation defended on the ground that the validity of the amendment had been duly declared by a decision of the highest court of Massachusetts. The Court of Appeals of New York rejected this defense, and the Supreme Court reversed its decision, saying that it is now the established rule, first, that the law of the state by which a corporation is created governs in enforcing the liability of a stockholder as a member of such corporation to pay the stock subscription which he agreed to make; second, that the state law and proceedings are binding as to the ascertaining of the fact of insolvency and of the amount due the creditors entitled to be paid from the subscription when collected; and, third, that by putting out of view the right of the person against whom a liability

for a stockholder's subscription is asserted to show that he is not a stockholder, or is not the holder of as many shares as is alleged, or has a claim against the corporation which at law or equity he is entitled to set off against the corporation, or has any other defense personal to himself, a decree against the corporation in a suit brought against it under the state law for the purpose of ascertaining its insolvency, compelling its liquidation, collecting sums due by stockholders for subscriptions to stock and paying the debts of the corporation, in so far as it determines these general matters, binds the stockholder, although he be not a party in a personal sense.

In the receiver's suit in Delaware, to which we have referred, the question of insolvency, the amount due the creditors, the sums due by stockholders on subscriptions to stock, were all duly determined, and here the defense, on the part of Himes, is based on the claim that he never was a subscriber for the stock of the corporation, but was a purchaser of stock from a going concern at a time when the corporation needed money for the payment of its debts and for the successful prosecution of its business. He, therefore, tells us that, notwithstanding the general rule may be that the holders of shares of stock which have been issued for an inadequate or illegal consideration, or for no consideration whatever, may be compelled to complete payment to the extent of the par value of such shares, the rule in the federal courts is that in the absence of constitutional or statutory provisions expressly forbidding it, a corporation which has previously issued shares of stock, incurred indebtedness, and acquired property which it is about to lose for want of additional capital, and is otherwise in financial difficulties, may issue and sell additional par value shares at less than par, provided the price paid is not less than the fair value of the shares purchased. He further says that when such purchase is made in good faith and without intent to defraud other shareholders or creditors, the purchaser is not liable for any additional payments to creditors or stockholders of the corporation. To sustain this position he relies upon Clark v. Bever, 139 U.S. 96, 11 S.Ct. 468, 35 L.Ed. 88, and Handley v. Stutz, 139 U.S. 417, 11 S.Ct. 530, 35 L.Ed. 227.

In Clark v. Bever an Iowa railroad corporation, which was unable to pay in full for construction work on its road, paid the contractor the balance due in its own stock at 20 per cent. of its par value. Subsequently the contractor was sued for the difference between the amount at which the stock was received and par. The Iowa statute provided:

"Nothing herein contained exempts the stockholders of any corporation from individual liability to the amount of the unpaid installments on the stock owned by them or transferred by them for the purpose of defrauding creditors, and an execution against the company may to that extent be levied upon such private property of any individual." Revision 1860, § 1172.

The Supreme Court held that the statute did not impose an express restriction upon the disposition by a corporation of its stock, except such as is imposed upon individuals, and did not prescribe any rule in respect to the liability of a stockholder to creditors except to the

extent of any "unpaid installments" on the stock owned by him. In this view, the Supreme Court said that in every such case the question is, first, whether any indebtedness really exists upon the part of the particular stockholder, and that this question must be determined in each case upon its own circumstances and in accordance with the principles of general law touching the rights and liabilities of creditors and stockholders. * * *

The case of Handley v. Stutz involved a Kentucky statute quite similar to that of Iowa. * * *

The court, however, recognized in this case, as in Clark v. Bever, that the rule of liability depended upon the state statute. Otherwise it is no more than an affirmance of the rule announced in that case, viz., that an "active corporation"—a "going concern"—finding its original capital impaired by loss may, to preserve the business, issue new stock and sell it at the best price that can be obtained.

Seeking to bring himself within this language, Himes says that the facts surrounding the purchase of his stock show that shortly after the granting of the charter to the corporation it issued and sold some of its stock at par (the record does not disclose how much). With the money thus realized it had purchased options to acquire parcels of land on which it intended to build an hotel; that in accomplishing this it had exhausted its treasury and was then in a precarious condition. It had options which it considered valuable, and which would terminate in a few days unless it was able to sell stock and realize sufficient funds to take up the options; and unless it could take up the options it could not proceed with the business for which it was incorporated. It had to sell its stock at what it could get for it to avoid receivership.

It was this situation, as Himes claims, which induced him to purchase the stock. He therefore insists that the case is like Handley v. Stutz in that here, as there, the corporation, finding its original capital impaired, for the purpose of recuperating itself and providing new conditions for the successful prosecution of its business, sold him the stock at the best price then obtainable; and so he says the rule announced there, when applied here, is a complete defense.

If we should grant Himes' premise and the facts on which he seeks to sustain it, we should still have another hurdle to cross for, as we have indicated already, both in Handley v. Stutz and in Clark v. Bever there was no controlling statute in the state of incorporation, and this was the basic factor in the result. But here, on behalf of the receiver it is claimed there is such statute law in Delaware, and it is further claimed its precise provisions make inapplicable the rule in Handley v. Stutz and Clark v. Bever. If this is correct, the judgment below, if for no other reason, is clearly wrong.

Prior to 1915 there was no statutory enactment of Delaware covering stockholders' liability for part paid stock. In 1915 section 14 (General Corporation Law of Delaware [Rev.Code Del.1915, § 1928]) was enacted as follows:

"Subscriptions to, or purchase of, the capital stock of any corporation organized or to be organized under any law of this State may

be paid for, wholly or partly, by cash, by labor done, by personal property or by real property or leases thereof. * * * And in the absence of actual fraud in the transaction, the judgment of the Directors, as to the value of such labor, property, real estate or leases [thereof], shall be conclusive."

Section 20 (Rev.Code Del.1915, § 1934) provided:

"When the whole capital stock of a corporation shall not have been paid in, and the assets shall be insufficient to satisfy the claims of its creditors, each stockholder shall be bound to pay on each share held by him the sum necessary to complete the amount of the par value of such share as fixed by the charter of the company or its certificate of incorporation, or such proportion of that sum as shall be required to satisfy the debts of the company," etc.

Section 20 was amended by Act March 20, 1917 (29 Del.Laws, c. 113, § 10), by adding a provision governing the issuance of no par value stock, but otherwise it remained unchanged, and was the law of Delaware at the time the charter of the corporation was granted and also at the time Himes' stock was acquired.

The section was construed and applied by the courts of Delaware in Cooney Company v. Arlington Hotel Co., 11 Del.Ch. 286, 101 A. 879, 887; Id., 11 Del.Ch. 430, 106 A. 39, 7 A.L.R. 955. * * *

As we read them, it is perfectly clear that the statutes of Delaware, as construed in that case, impose an absolute liability on the holders of stock of a corporation of that state—original or subsequent—to pay the full par value of the shares so held. And this is also the rule in New Jersey, from whose incorporation laws section 20 of the Delaware statute was taken. In Donald v. Am. Smelt. & R. Co., 62 N.J. Eq. 729, 48 A. 771, 1116, Easton N. Bk. v. American B. & T. Co., 70 N.J.Eq. 732, 64 A. 917, 8 L.R.A.,N.S., 271, 10 Ann.Cas. 84, and Holcombe v. Trenton W. C. Co., 80 N.J.Eq. 122, 82 A. 618, it was stated flatly that whether the stock be paid for in property or money, the value of the property or the amount of the money in either case must be at least equal to the face value of the stock. In view of these decisions and the established rule that in the interpretation of state statutes we are bound to follow the rulings of the highest court of the state, it is perfectly clear that the rule in Clark v. Bever and Handley v. Stutz cannot be considered as controlling here; and this same view was taken by the Court of Appeals in the Second Circuit in Enright v. Heckscher, 240 F. 863, 879. In that case one of the questions for decision was whether the New Jersey act was so explicit as to foreclose the question whether an indebtedness claimed against stockholders may be determined by other circumstances like those in Handley v. Stutz and Clark v. Bever.

Judge Rogers, who wrote the opinion, reached the conclusion that a fair construction of the New Jersey act would not permit a defense on those or like issues of fact.

But even if we were in doubt as to these questions, we should still be inclined to the view that Himes has not otherwise brought himself within the doctrine or rule of those two cases. In Handley v. Stutz the corporation was an active, going concern. Its original cap-

ital stock had been subscribed and used, its business established, and it was only at a later date—some three years in fact—that in order to extend its business and increase its ability to conduct it successfully, it increased its stock and sold it on the best market.

In Clark v. Bever a railroad company charged with a public duty found itself unable to pay its floating debt or the interest on its bonds. To avoid failure, it issued its stock at 20 per cent. of par (all it was then worth) in payment of a debt. These were the circumstances which the Supreme Court held removed the case from the usual rule of stockholders' liability, but the decision in both cases turned upon the fact that the company was a going business and should not be deprived of the opportunity to keep itself alive by selling its stock at less than par if there were no statute in the state of its incorporation forbidding it.

That is not the case here. The corporation we are concerned with was not an active corporation, a going concern, or an established business when Himes acquired his stock. It had been chartered only three months. In that interval it had sold a part of its stock, how large a part is not disclosed. On the one hand, its application for the amendment shows the affirmative vote of all the then authorized stock, but the stock ledger (Exhibit C) shows that prior to Himes' purchase certificates for only 44 shares of preferred and 40 shares of common had been issued, and only $8,400 in cash received. Out of this small amount of money it had acquired options on parcels of land, but it had not got beyond that stage. It had neither hotel nor site on which to build it. It had options, but it could not do business on options alone. Necessarily, it had discharged none of the functions for which it was incorporated. It was a paper corporation, but that was all. It was in that respect wholly unlike either of the corporations in Clark v. Bever and Handley v. Stutz. It had never prosecuted any business, and was wholly in the preliminary stages, and the contract with Himes contemplated that $10,000 of his subscription might be used for the purpose of a campaign to sell the stock. The increase of stock under the amended charter was, in the circumstances we have detailed, as much an original issue of stock as if issued under the original charter provisions for, whether previously subscribed for or not, the record shows that a negligible percentage had then been issued or paid for. In view of this, it would be a stretch of imagination to say that the facts bring the case within the so-called "Supreme Court rule." Nor do we think there is any difference in the fact that Himes purchased rather than subscribed for stock. The "acceptance of the certificates is sufficient evidence of an agreement to pay their par value." Handley v. Stutz, 139 U.S. 417, at page 427, 11 S.Ct. 530, 534, 35 L.Ed. 227. * * *

Reversed.

(b) No par value stock

Under the corporation statutes of most states there are two distinct types of non-par stock. The first type is referred to as stated value non-par stock. The corporation statutes, while calling their

creation shares "without nominal or par value," have, in effect, achieved a definite par value stock. The second is referred to as true non-par stock because of the absence of any statement other than the number of non-par shares to be issued. The stock is merely authorized to be brought into existence. Many states, however, do require the incorporators to certify that a minimum paid-in capital fund has been paid in at commencement of corporate life where true non-par stock is created. Berle, Studies in Law of Corporation Finance (1928) pp. 65–67.

NEW YORK STOCK CORPORATION LAW

§ 12. *Shares without par value.* Any or all of the shares of any stock corporation, other than a moneyed corporation, may be issued without par value, provided there be included in its certificate of incorporation the following statements:

1. The total number of shares that may be issued by the corporation.
2. The number of shares, if any, which are to have a par value and the par value of each.
3. The number of shares which are to be without par value, and
4. Either one of the following statements:

A. "The capital of the corporation shall be at least equal to the sum of the aggregate par value of all issued shares having par value, plus ...... dollars (the blank space being filled in with some number representing one dollar or more) in respect to every issued share without par value, plus such amounts as, from time to time, by resolution of the board of directors, may be transferred thereto;" or

B. "The capital of the corporation shall be at least equal to the sum of the aggregate par value of all issued shares having par value, plus the aggregate amount of consideration received by the corporation for the issuance of shares without par value, plus such amounts as, from time to time, by resolution of the board of directors, may be transferred thereto."

There may also be included in such certificate an additional statement that the capital shall not be less than ...... dollars (the blank space being filled in with a number).

Such statements in the certificate shall be in lieu of any statements prescribed by the law under which the corporation is formed as to the amount or maximum amount of its capital stock or the number of shares into which the same shall be divided, or of which it shall consist.

Subject to the designations, preferences, privileges and voting powers or restrictions or qualifications granted or imposed in respect to any class of shares, each share with or without par value shall be equal to every other share of the same class.

DELAWARE GENERAL CORPORATION LAW

§ 14. * * * As to corporations incorporated prior to April 1, 1929, shares of capital stock without par value, whether common or

preferred or special, may be issued by the corporation from time to time for such consideration as may be fixed from time to time by the Board of Directors thereof, pursuant to authority conferred by the Certificate of Incorporation or, if such authority shall not be so conferred on the Board of Directors, then for such consideration as may be fixed by the consent in writing of, or by vote of, the holders of record of two-thirds of the total number of shares of each class of stock then outstanding and entitled to vote in respect thereto, such vote to be given at a meeting called for that purpose in such manner as shall be prescribed by the by-laws. As to corporations incorporated on or after April 1, 1929, shares of capital stock without par value, whether common or preferred or special, may be issued by the corporation from time to time for such consideration as may be fixed from time to time by the Board of Directors thereof, unless in the Certificate of Incorporation the power to fix such consideration shall have been reserved to the stockholders, in which event such power shall be exercised by the stockholders by consent in writing or by vote of the holders of record of two-thirds of the total number of shares of each class of stock then outstanding and entitled to vote in respect thereto, said vote being given at a meeting called for the purpose in such manner as shall be prescribed by the by-laws; provided that, although such power has been reserved to the stockholders, the directors shall nevertheless have power to fix such consideration for the first issue of stock, and such issue shall not exceed ten per centum of the whole amount of such stock authorized by the Certificate of Incorporation. Any and all shares without par value so issued for which the consideration so fixed has been paid or delivered shall be deemed full paid stock and shall not be liable to any further call or assessments thereon, and the holders of such shares shall not be liable for any further payments in respect of such shares under the provisions of this Chapter. * * *

STONE v. YOUNG.

Supreme Court of New York, Appellate Division, Fourth Department, 1924.
210 App.Div. 303, 206 N.Y.S. 95.

Appeal by the plaintiff, Walter R. Stone, as receiver, etc., from a judgment of the Supreme Court in favor of the defendant, entered in the office of the clerk of the county of Onondaga on the 7th day of May, 1924, pursuant to an order, made at the Onondaga Special Term and entered in said clerk's office on the 6th day of May, 1924, dismissing the complaint for failure to state facts sufficient to constitute a cause of action.

See 123 Misc. 120, 204 N.Y.S. 690.

SEARS, J. The defendant, during the month of December, 1921, subscribed in writing for 200 shares of the 8 per cent. cumulative, nonassessable, preferred stock of the Syracuse Hotel Corporation, of the par value of $100 each, with which, according to the subscription agreement, he was to receive a bonus at the rate of one share of the

common stock without par value with each two shares of preferred. The subscription agreement provided that the payment of the subscription price should be made in installments upon fixed dates, and that the certificates for the shares purchased were not to be delivered to the subscriber, except in proportion to the payments as specified. It also contained the following paragraph:

"Interest at the rate of 6 per cent. on preferred stock to accrue, respectively, from the date of each installment payment until the beginning of the first quarter after date of opening of the hotel, after which date the dividend will be 8 per cent. on such preferred stock."

In an action in the United States District Court the plaintiff has been appointed receiver of the Syracuse Hotel Corporation, and that court has ordered and adjudged, among other things, that it is necessary for the protection of creditors of the Syracuse Hotel Corporation, and for the payment of its debts, obligations, and liabilities, that all moneys due and owing and which should become due and owing upon subscriptions for the stock of such corporation be forthwith paid to the receiver, and the receiver has been further authorized to make a call and demand upon all persons owing moneys because of subscriptions to the stock to pay to him as such receiver forthwith all sums due and owing, respectively, by them because of such subscriptions, and in the case of installments not then due to make a call and demand for payment of such installments when and as they became due and payable, and to take any necessary action and institute such suits as the receiver might be advised for the purpose of enforcing payment of the sums ordered to be paid.

The defendant has paid $13,000 of the agreed subscription price of $20,000, and this suit is brought to recover the balance, with interest.

The foregoing are the main allegations in the complaint. The defendant, by motion for judgment, has challenged the sufficiency of the complaint on the ground that the subscription agreement is invalid. * * *

2. Because the contract provides for a distribution of common stock without the receipt of any value therefor (Stock Corporation Law of 1909, § 55 and section 19, as added by Laws 1912, c. 351, amended by Laws 1917, c. 500, § 1, and Laws 1921, c. 694).

The parties entered into a stipulation for use upon the motion to the effect that the Syracuse Hotel Corporation at the time of the execution and delivery by the defendant of the stock subscription in question had not yet engaged in business and had no assets, property or income other than the cash received from the sale of stock. * * *

The other claim of invalidity includes two propositions: First, that the preferred shares could not be subscribed for in money at less than the full par value of the shares; and, second, that the company could not lawfully distribute gratuitously its common stock, even if it was without par value.

The first of these two propositions rests on the provision of the statute:

"No corporation shall issue either stock or bonds except for money, labor done or property actually received for the use and lawful purposes of such corporation." Section 55, Stock Corporation Law 1909.[46]

It is true that the statute at the time of the execution of the subscription in question did not contain an express prohibition against the issuance of shares of stock with par value for money at less than the par value such as was contained in the statute from 1892 to 1901 (Stock Corporation Law 1892 [Gen.Laws, c. 36; Laws 1892, c. 688] § 42, and chapter 354, Laws 1901), and as is contained in the present Stock Corporation Law (Consol. Laws, c. 59; section 69, c. 787, Laws 1923). But in the statute as a whole, particularly in sections 9, 19, 55, 56, and 60 of the Stock Corporation Law of 1909, the requirement is clearly implied that stock with par value when issued for money shall be issued only for a consideration at least equal to the par value. In Gamble v. Queens County Water Co., 123 N.Y. 91, 25 N.E. 201, 9 L.R.A. 527, such a requirement was held to be implied in a statute very similar to the one under which this corporation was organized. In Trent Import Co. v. Wheelwright, 118 Md. 249, 84 A. 543, the Court of Appeals of Maryland construed the antecedent of the very statute of New York under which the Syracuse Hotel Corporation was organized as forbidding an issue of stock with par value for less than the equivalent of such value. Section 42 of the Stock Corporation Law of 1890 (Gen.Laws, c. 36; Laws 1890, c. 564), as amended by chapter 688, Laws 1892, contained these words: "No such stock shall be issued for less than its par value." When this act was amended in 1901 (chapter 354, Laws 1901), this sentence was omitted. In our opinion, however, the Legislature, by omitting these words, did not intend to change the policy of the state in this respect. At the time of the adoption of the amendment with the words omitted, the following provision was added:

"Any corporation may purchase any property authorized by its certificate of incorporation, or necessary for the use and lawful purposes of such corporation, and may issue stock to the amount of the value thereof in payment therefor, and the stock so issued shall be full paid stock and not liable to any further call, neither shall the holder thereof be liable for any further payment under any of the provisions of this act; and in the absence of fraud in the transaction the judgment of the directors as to the value of the property purchased shall be conclusive."

This sentence liberalized the law with relation to the issuance of stock for property by making the value of the property as determined by the directors in good faith, and not the actual value of the property, the test in respect to full payment. The provision contained in the quoted words is inconsistent with that which was omitted, so far as that provision related to stock issued for property, and probably the omission occurred on that account. The statute was re-enacted in section 55 of the Stock Corporation Law of 1909. Some light is

[46] *Cf.* N.Y.Stock Corporation Law, § 69, *infra*, p. 355.

shed upon the legislative purpose by the enactment of 1923 (section 69, c. 787, Laws 1923), where the section was again amended by inserting the words:

"No shares of stock having par value shall be issued for money in an amount less than the par value of such shares."

Stock issued for property may in fact, though not intention, be "watered." Stock issued for cash must be full-paid to the par value. It is for this reason that the statute requires in the same section that:

"In all statements and reports of the corporation, by law required to be published or filed, this stock [issued for property] shall not be stated or reported as being issued for cash paid to the corporation, but shall be reported as issued for property purchased."

Unless the Legislature intended that the corporation should receive the par value of all stock having a par value, the purpose of having a par value at all disappears. Knowlton v. Congress & Empire Spring Co., 57 N.Y. 518; 36 Harvard Law Review, 509–547;[47] 14 Corpus Juris, 444, note. Christensen v. Eno, 106 N.Y. 97, 12 N.E. 648, 60 Am.Rep. 429, and Southworth v. Morgan, 205 N.Y. 293, 98 N.E. 490, 51 L.R.A.,N.S., 56, determined that stock of a foreign corporation actually issued, either gratuitously or for a money consideration less than the par value of the shares, will, in an action by a creditor, founded solely on the common law, be treated as fully paid, so that the holder of such shares will not be liable to the creditor for the difference between the par value and the amount the corporation received as consideration. These cases repudiate the "trust fund theory" recognized in some jurisdictions. They relate to executed contracts only, are based on the common law, and bear no relation to the question of the enforceability under our statutes of an executory contract embodying the issuance of intentionally "watered" stock.

If, as we think, the statute forbade the issuance of stock with par value for a money consideration less than par, an agreement in conflict therewith, while executory, is unenforceable. Kraft v. Griffon Co., 82 App.Div. 29, 81 N.Y.S. 438; Zelaya Mining Co. v. Meyer, City Ct., 8 N.Y.S. 487; General Electric Co. v. Wightman, 3 App.Div. 118, 39 N.Y.S. 420; 14 C.J. 448; Village of Ft. Edward v. Fish, 156 N.Y. 363, 50 N.E. 973. The subscription agreement set forth in the complaint is executory, so far as it concerns the balance unpaid. Oregon R. & Nav. Co. v. Oregonian R. Co., 130 U.S. 1, 9 S.Ct. 409, 32 L. Ed. 837. We reach the conclusion then that the sum which the defendant agreed to pay was a consideration solely for the preferred stock and that the common stock was to be distributed literally as a bonus or gratuity. Although this common stock is without par value, the very section of the statute which authorizes the issuance of such stock (section 19, Stock Corporation Law of 1909, added by Laws 1912, c. 351, as amended by chapter 694, Laws 1921),[48] also determines the consideration which must be paid for it upon its issu-

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47 Warren, Safeguarding the Creditors of Corporation, 1923, 36 Harv.L.Rev. 509.

48 N.Y.Laws 1921, c. 694, § 19, deals with the issue of non-par stock. *Cf.* N.Y. Stock Corporation Law, § 12, *supra*, p. 283.

ance by providing that the corporation may issue and sell such shares "for such consideration as may be prescribed in the certificate of incorporation or for such consideration as shall be the fair market value of such shares." Here is no warrant for the gratuitous distribution. In fact, an original distribution without consideration is in direct conflict with section 55 of the Stock Corporation Law of 1909, as it then existed.

In view of the stipulation that the corporation, at the time of the execution of the subscription agreement, had no assets, property, or income other than cash received from the sale of stock, it is evident that the corporation owned no already issued common stock which might possibly be distributed as a bonus. The case differs in this respect from Skillin v. Magnus, D.C., 162 F. 689.

The invalidity which has been pointed out goes to the very essence of the agreement and affects the entire instrument. Foley v. Speir, 100 N.Y. 552, 3 N.E. 477; Trent Import Co. v. Wheelwright, supra. * * *

The judgment should be modified, by granting the plaintiff permission to serve an amended complaint within 20 days, and, as so amended, affirmed, with costs. * * *

JOHNSON v. LOUISVILLE TRUST CO.

Circuit Court of Appeals of the United States, Sixth Circuit, 1923.
293 F. 857.

Petition to revise an order of, and appeal from, the District Court of the United States for the Western District of Kentucky.

Proceeding by Claude W. Johnson, trustee in bankruptcy of the Kentucky Iron & Steel Company, bankrupt, against the Louisville Trust Company, trustee, and others. An order of the referee dismissing the petition was affirmed by the District Court, and the trustee seeks review, both by appeal and by petition for revision under Bankruptcy Act, sec. 24, sub. b, 11 U.S.C.A. § 47, sub. b.[49] Affirmed.

KNAPPEN, Circuit Judge. The Louisville Trust Company, as trustee for certain individuals, had purchased at bankruptcy sale the plant and assets of the Louisville Steel & Iron Company, the substantial consideration being the cancellation of a bond issue of $200,000. On April 20, 1920, the trust company, as such trustee, gave respondents Tietjen and J. Walter Bell an option for the purchase of this plant and personal property, to be conveyed to a corporation to be organized by the optionees, and having an authorized issue of $150,000 of preferred stock and 3,000 shares of no par value common stock, of which the trust company, as such trustee, was to receive as payment for such plant and personalty $50,000 preferred and 750 shares of no par value common stock, plus $100,000 of an issue of $150,000 of mortgage bonds to be placed on the property by the new corpora-

[49] The present provision of the Federal Bankruptcy Act dealing with jurisdiction of appellate courts appears in 52 Stat. 854, 1938, 11 U.S.C.A. § 47.

ital into the treasury of the new corporation, to be used for necessary repairs, alterations, and operation. This option was accepted on or about May 4, 1920. Pursuant to this arrangement, the present bankrupt, the Kentucky Iron & Steel Company, was organized under the laws of Delaware, with authority to issue preferred and no par value common stock in the agreed amounts above stated; the three incorporators, of whom Tietjen was one, subscribing each for 5 shares of such common stock. On the same day the incorporators, acting by proxy, elected five directors, of whom Tietjen was one, and on the same day, at Wilmington, Del., by the affirmative vote of all present, adopted a resolution reciting the option and its acceptance; also an offer by the optionees to sell and assign the option and all rights thereunder to the new corporation, in consideration of the issue to the optionees of 2,250 shares of no par value common stock, and authorizing the board of directors to purchase the option at the price stated and to issue such stock in payment; also to carry out the option according to its terms, and purchase the plant and assets in question, and give a mortgage thereon to secure the bonds before referred to; and to issue in payment for the plant and assets the preferred stock and no par value common stock and mortgage bonds in amounts provided in the option.

On June 1, 1920, at its first meeting (at Louisville), the board of directors (Tietjen not voting) adopted a resolution accepting the offer of the optionees to sell the option, approving the terms thereof, and authorizing the president and secretary to accept and carry it out, to make and deliver all necessary agreements for the purchase of the property, and specifically authorizing and directing those officers to issue to the optionees certificates for the no par value common stock, and to the order of the Louisville Trust Company, trustee, certificates for the no par value common stock and the full-paid and nonassessable preferred stock, and the mortgage bonds in the same amounts as were provided by the option and by the stockholders' action, said preferred and common stock (full-paid and nonassessable) and bonds to be in full payment for said property, in accordance with the terms of said option; also authorizing the executive committee of the board to borrow on the company's behalf $50,000 and to pledge as collateral security for the payment thereof the remaining $50,000 of the company's first mortgage bonds. The president and secretary were later authorized by the executive committee to execute and deliver the notes and agreement on consideration of the payment of such $50,000. The trust company received and retained the certificates for both classes of stock. The certificates for the 2,250 shares of no par value common stock were issued to Tietjen, and by him endorsed and delivered to respondent J. Walter Bell, who continued to hold or control them. A considerable sum was expended in altering or rebuilding the plat and putting it into operable condition, and for several months the transaction of business by the new company was attempted; but on January 19, 1921, it was adjudged bankrupt.

Meanwhile, J. Walter Bell had advanced $50,000 to the new company for the purposes stated in the option agreement, and had taken as security therefor the remaining $50,000 of mortgage bonds, which he claims to have sold to his wife, the respondent Phyllis W. Bell, J. Walter Bell also claims to have advanced to the bankrupt a further sum of $65,153.22, the claim wherefor he assigned to the respondent Ira L. McCord. At bankruptcy sale the trust company bid in the entire of the bankrupt's property, paying into court the stipulated value of the free assets, so leaving available for distribution to general or unsecured creditors (amounting to approximately $220,000, including the deficiency mortgage claim of the trust company) not more than $7,000, after payment of wage claims, expenses of administration, and other priorities. Thereupon this proceeding was instituted by the trustee in bankruptcy for the recovery from the trust company, trustee, as for unpaid stock, of $50,000 on account of the preferred and $75,000 on account of the no par value common stock, and from Tietjen and J. Walter Bell, jointly and severally, for common stock liability, $225,000. Payment upon the claims of Ira L. McCord and Mrs. Bell was sought to be stayed pending the hearing of the main issues. After hearing upon the merits, the referee denied and dismissed the petition for assessment of stockholders' liability as to both preferred and no par value stock. Upon review the District Court affirmed the referee's order. The trustee in bankruptcy seeks review of the action of the District Court both by appeal and by revision under section 24b of the Bankruptcy Act [11 U.S.C.A. § 47, sub. b.] * * *

4. The Common Stock.—Section 20 of the Delaware statute [59] [Rev.Code Del.1915, § 1934] already referred to in part, further declares that in the case of stock without par value, this liability (for unpaid portion of part-paid stock) shall be limited to the unpaid balance of the consideration for which the stock was issued by the corporation. As to the 750 shares of no par value common stock issued to the trust company, trustee, the referee thought that no consideration therefor was fixed by the board of directors; that stock was simply "thrown in" with the securities which had an ascertainable value, and therefore the 750 shares issued to the trust company, trustee, were void.

As to the shares issued to Bell and Tietjen, the directors expressly "adjudged and declared that said option is worth 2,250 shares of common stock of this company, without nominal or par value." The referee thought that a consideration was thus found by the board in the value of the option taken over by the bankrupt, saying that, "while the option finally proved to be worthless, so did the common stock." We find it unnecessary to consider whether the referee correctly treated the 750 shares as void, nor whether, as contended by the trustee in bankruptcy, the option failed to furnish a lawful consideration for the issue of stock under the Delaware constitution, as being neither cash, labor, personal property, real property, nor leases thereof.

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[59] Del.Rev.Code 1915, § 20, *infra*, p. 357.

In ultimate legal effect, the promoters and incorporators determined that, if this manufacturing experiment succeeded, those organizing it and contributing to its success were entitled to share the net earnings (above dividends on preferred stock), and, in case of corporate dissolution, the net assets remaining after payment of debts, in the proportions represented by the respective amounts of the no par value stock given. If it be thought that the corporate action, considered in its entirety, failed to declare "the consideration for which the stock was issued by the corporation," or that such consideration was extralegal, what is the result? We find no warrant whatever for the contention of the trustee in bankruptcy that he thereby became entitled to recover from those engaged in this unsuccessful experiment such an amount as may be found necessary to meet the payment of creditors' claims and the expenses of bankruptcy administration. State legislation providing for no par value stock was inaugurated more than 10 years ago. Numerous states have since made similar provision. The wisdom of this legislation is not before us, although we are not to be understood as discrediting it. Indeed, very many competent jurists and financiers regard the evils of no par value stock less than those frequently incident to the issue and sale of stock having a par value. In at least three states, Delaware corporations having stock with no par value have been held qualified to do business. North American Petroleum Co. v. State Charter Board, 105 Kan. 161, 181 P. 625; State ex rel. Standard Tank Car Co. v. Sullivan, 282 Mo. 261, 221 S.W. 728; Detroit Mortg. Corporation v. Secretary of State, 211 Mich. 320, 178 N.W. 697, 182 N.W. 526.

We are cited to no authority, nor have we found any, supporting the right to the recovery asserted by the trustee in bankruptcy. On the contrary, the generally, if not universally, accepted theory of the purpose of such statutes is that they are intended to do away with both the "trust fund" and "holding out" doctrines. We refer in the margin to three valuable and interesting articles in the American Bar Association Journal[51] upon the subject of no par value stock. As Mr. Cook says:

"The whole theory of stock without par value is 'let the buyer beware' and 'let the creditor beware.' "

Granting that the courts should compel the payment of the consideration for which the no par value stock was issued by the corporation, it would seem, not only that the consideration contemplated by the corporation and its promoters has been paid, but also that the no par value stock had no tangible value.

We have found it unnecessary to consider all of the interesting suggestions and arguments presented.

The decree of the District Court is affirmed.[52]

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51 Colton, Par Value versus No Par Value Stock, 1921, 7 A.B.A.J. 671; Cook, Stock Without Par Value, 1921, 7 A.B.A.J. 534; Hollen and Tuttle, Uses of Stock Having No Par Value, 1921, 7 A.B.A.J. 579.

52 Certiorari denied 264 U.S. 585, 44 S.Ct. 334, 68 L.Ed. 862, 1923. On the liability to creditors of holders of non-par stock, see Berle, Problems of Non Par Stock, 1925, 25 Col.L.Rev. 43, 52; Bonbright, Dangers of Shares Without Par Value, 1924, 24 Col.L.Rev. 449; Masterson, Consideration for Non Par Shares and Liability of Subscribers and Stockholders, 1939, 17 Tex.L.Rev. 247.

ATLANTIC REFINING CO. v. HODGMAN et al. SUPERIOR OIL CORPORATION v. SAME.

Circuit Court of Appeals of the United States, Third Circuit, 1926.
13 F.2d 781.

Appeal from the District Court of the United States for the District of Delaware.

Suit by Marshall Hodgman and others against the Atlantic Refining Company and the Superior Oil Corporation. From a decree for plaintiff (300 F. 590), defendants separately appeal. Reversed and remanded, with directions.

See, also, 2 F.2d 893, and 8 F.2d 777.

BUFFINGTON, CIRCUIT JUDGE. This bill was brought by individual stockholders of the Superior Oil Corporation, hereafter called Superior, against the Atlantic Refining Company, hereafter called Atlantic, to enforce rights of the former company against the latter. The majority stockholders of Superior and the officers of Superior having declined to seek such relief, the bill was brought by the plaintiff stockholders against Atlantic, and Superior also was made a defendant.

Aligning the parties according to interest, the real plaintiff before us and the party whose rights are to be proven and established is the Superior Oil Corporation and the real right of action here involved is the right, if any, of that company against the Atlantic Company. Viewing the action, then, as that of Superior against Atlantic, what are the rights of Superior against Atlantic, and what are the responsibilities of Atlantic to Superior? If we correctly determine the rights and obligations of these two corporations to each other, we have the foundation on which this case must properly be adjudged.

Superior was a corporation of the state of Delaware, and by virtue of its corporate powers was engaged in the production and sale of petroleum. Atlantic was a corporation of the state of Pennsylvania, and, in addition to producing oil, was engaged in manufacturing illuminating and lubricating oils and other products of petroleum. Contemplating an expansion of its business by buying additional oil properties, Superior, on March 4, 1920, secured from Atlantic, a loan of $2,750,000. This was effected by a contract of that date between Superior, Atlantic, and the former's president, Robert M. Catts, designated trustee, "for the sole purpose of carrying out the terms and conditions of this contract duly authorized by the board of directors" of Superior. * * * the gist of the contract was that Superior was acquiring further oil properties, and was taking them in the name of its president, Catts, as trustee; that Atlantic was advancing the funds to Catts to acquire such properties; that Superior was assuming the debt; that to pay it Superior was setting aside one-third of its production at the prices set by the Seep Agency; that in case of default it was turning over its property and management to Atlantic until its debt was paid; and that, pending the loan, Superior was, for the purpose of Atlantic's protecting its loan, allowing on its board a director nominated by Atlantic, who had no financial interest in Superior.

Meanwhile one-third of Superior's income was by contract allocated to the loan, another one-third to specific work heretofore noted, leaving but one-third free for Superior Control. * * * Superior was, from the start, falling behind in its daily payment of $2,750 required by the contract. * * *

With this contract in force, which left Superior with a limited working capital, without power to increase its capital stock or to finance the acquisition of additional properties, Superior found itself in a condition which it outlined in a letter of May 29, 1920, wherein the facts are stated, viz.: (1) That its "early operations were comparatively limited in scope, and it was deemed wise to increase the area of its producing properties"; (2) in view of its "pipe line capacity, which is now materially in excess of present production"; and (3) that it should have "additional working capital provided through sale or exchange of 1,118,478 shares of new stock". * * * a conditional contract, dated June 24, 1920, covering Superior's production for 10 years, by Atlantic, was entered into. * * * this contract provided that, if Superior paid off its debt to Atlantic, then Atlantic's contract to take Superior's product for 10 years then, and then only, came into effect. * * *

* * * to enable Superior to finance its plan (to issue new stock) and thus acquire the additional oil property needed to pay off its daily loan requirement and obtain new capital, four things were necessary: (1) To induce Atlantic to exchange its indebtedness for stock; (2) to tie up its stock so acquired for two years; (3) to take Superior's entire product for 10 years instead of 5; and (4) to assume the management of Superior's properties. * * * these were the bankers' requirements * * *

* * * when this contract for 10 years' oil production was being considered by Superior at the directors' meeting * * * Director Henry, who * * * was the representative of Atlantic on Superior's board to safeguard its loan, stated that his company, "provided that so to do in any instance would not work to its own disadvantage, would at any time be glad to waive its right so to purchase under the terms of the contract, if the Superior Company deemed it advantageous to sell that oil elsewhere." * * *

* * * no contract between Atlantic and Superior other than the 10-year oil provisional contract based on the bankers' requirement, had resulted therefrom when, on August 5, 1920, the corporate written contract between Atlantic and Superior here involved was made. On that day * * * a letter of Atlantic to Superior was presented at the directors' meeting, as follows: "* * * Gentlemen: The undersigned company, under agreements with your company, to which we refer, has loaned and advanced moneys for the purchase of properties by your corporation and the charges and expenses incident thereto incurred by your corporation and ourselves. We are informed that Messrs. Brown Brothers White, Weld & Co., Graham, Parsons & Co., and Frazier & Co., proposed to loan your corporation the sum of $2,-910,000, and to accept in payment thereof, under certain contingencies, 181,875 shares of stock of the Superior Oil Corporation.

"We hereby offer to accept 325,000 shares of the stock of your corporation, issued full-paid and nonassessable in full payment of the principal sum of all your indebtedness to us, * * * Our acceptance is conditional upon your delivery to the aforementioned firms of 181,875 shares of your stock in payment of their loan to you, and furthermore conditional upon the aforementioned firms' purchase from your corporation 81,500 shares at $16 per share. Subject to the approval of your board of directors, we will accept from R. M. Catts, trustee, 86,666 shares of your capital stock now held by us as part payment of the 325,000 shares we offer to accept, leaving certificates for 283,334 shares of your stock to be delivered to us. * * *

"This offer is made subject to the resolution of your board of directors * * * and without in any way affecting our contract of June 24, 1920, with your corporation for the purchase of crude petroleum for the period of ten years.

"The Atlantic Refining Company,

"By (signed) W. M. Irish, Vice President."

"Thereupon, on motion duly made and seconded, it was unanimously resolved, that the board of directors hereby accept the offer of the Atlantic Refining Company * * * upon the terms thereof: * * *"

In pursuance of this resolution, an account was stated which showed Superior was entitled to credits on its indebtedness of $295,787.78. This sum, deducted from its indebtedness to Atlantic, which Atlantic paid to Superior by check * * * left Superior's indebtedness to Atlantic $2,750,000, which made the cost to Atlantic of the 325,000 shares of stock about $8.54 per share. * * * this contract obtained for Superior from Atlantic additional funds, and enabled it to pay off its debt to Atlantic, and thereby make the conditional 10-year contract an absolute one, * * *

* * * very shortly trouble arose in the newly constituted management, which, on November 20, 1920, resulted in Catts, the president of Superior, writing a letter to the executive committee of the latter, objecting to a continuation of what he termed dual management, namely, the executive committee and himself. Thereupon the Atlantic Company, which was advised of such situation, notified Superior of its willingness to rescind the new contract, the 10-year oil contract, surrender its stock, and restore the status of debtor and creditor as they had existed. This offer * * * was not accepted by Superior * * *

The proofs show that oil was then selling between $4.25 and $4.50 per barrel, and the stock of Superior was selling at from $11 to $12 per share. On February 18, 1921, certain stockholders of Superior notified that company that this acquisition of stock of Superior by Atlantic at $8 per share, when the company was realizing $16 from others, was "unlawful and invalid, that a great injustice was done to the Superior Oil Corporation, and that a large loss was suffered by it. It is the imperative duty of the directors and officers of the Superior Company to see that this injustice is righted, that the transaction is rescinded, and that the resultant loss to the Superior Oil Corporation shall be recovered, and toward that end I demand of the officers and

directors of the Superior Oil Corporation that proper actions be promptly instituted by them in the courts * * *" The notice also alleged that the 10-year oil contract was unlawful, in that it was procured by Atlantic when a majority of Superior's directors were agents of Atlantic, and when Superior's board of directors was dominated by Atlantic. On Superior's failing to bring suit, the present action was brought by such shareholders in behalf of Superior. * * *

* * * the trial court found that Superior had no legal power to sell the stock in question at $8 per share and that Atlantic, in paying $8 a share for such stock, perpetrated a fraud on Superior. After a full argument of the case and due consideration, we are of the opinion the court, in so doing fell into error, and that it should have dismissed the bill. * * *

We turn next to the alleged wrong done to the stockholders of Superior. The outstanding stock of Superior was over 900,000 shares. What is their attitude towards this alleged fraud? The holders of some 10,000 shares of the stock bring this bill, alleging fraud in this contract, while, leaving entirely out the 325,000 shares owned by Atlantic, which took no part in such action, the holders of 137,161 shares of the stock, in person or by proxy, attended a stockholders' meeting held on March 28, 1922, and voted unanimously in approval of the action of Superior in declining the offer of Atlantic of December 20, 1920, to return the stock purchased by Atlantic, to rescind the 10-year production contract and restore the pre-August, 1920, status.

Deferring, for a later consideration, the alleged misrepresentations, fraudulent concealments, and other acts which are said to have brought about this contract, and confining ourselves to the contract as a contract to sell stock of the same issue to different persons at different prices, we address ourselves to the charge of the bill, viz.: "Your orators are informed and believe, and therefore allege, that the transaction by which the refining company acquired said 325,000 shares of the capital stock of the Superior was in violation of the statutes of Delaware in such case made and provided, and it was therefore illegal and ultra vires." Since the decree was entered below, the case of Bodell v. General Gas & Electric Corporation, 15 Del.Ch. 119, 132 A. 442, in which the Court of Chancery of Delaware considered the action of a Delaware corporation in selling stock of the same issue at different prices to different persons, has been decided. It is therefore due to the court below to say that this court has the benefit of an enlightening and authoritative pronouncement which the lower court did not have. Without quoting at length from the exhaustive opinion there delivered, we confine ourselves to such references as particularly apply to our case. To our mind, the basic principle of that case, which permits such different stock prices to different persons, is summed up by the chancery court in these words:

"The mere showing of the two prices would, without satisfactory explanation, undoubtedly entitle the complainants to relief. But, if these two prices are justified by a showing of fairness in the light of all the circumstances, so that what appears to be an injury turns out to be a benefit to those complaining, there can be no ground for inter-

ference. If the directors, in the course they are pursuing, are acting in genuine and beneficial interest of the corporation, and are thereby promoting the interests of all stockholders in a very tangible way, and especially the interests of the class of stockholders who are complaining, why should not the general principles applicable to persons standing in trust relationships come to their supporting aid?"

In that case, as in this, there was the element of the requirement of bankers marketing the stock and also the sale of some stock to certain persons at $25, which factors enabled the bankers to market the residue of the stock at $45. Of this situation, the chancery court says:

"This policy, it is claimed, made the sale of the additional stock an easy matter, for, in addition to the regular dividend of $1.50 a year which the stock was paying, the announced policy held out to purchasers the prospect, just referred to, of making a profit on the stock they might take at $25 for their regular dividends. Thus, to use an old expression, the stock lifted itself by its own boot straps. If the value of $45 per share is thus created by the combined action of the announced policy and the creation of market prices by the sustaining operations of the bankers on the exchange, it is manifest that $45, the price which was concurrently obtained by the corporation when it was announced that class A dividends would be allowed to buy it at $25 per share, does not represent a sales price which the directors can in fairness be held to. It would be highly unreasonable to point to sales at $45 as showing the inadequacy of sales at $25, if the latter was what in fact made the former possible."

It will thus be seen that, while an arbitrary sale of the same issue of stock at different prices to different parties at the same time is *prima facie* bad, sales will be sustained, if based on business and commercial facts, which, in the exercise of fair business judgment, lead directors to follow such a course.

Under the proofs in this case, we think the situation was one that necessarily gave the directors of Superior a zone of discretion as to this proposed issue of stock. Superior was in debt, and its oil production was not sufficient to make the stipulated payments on its debt to Atlantic, and consequently Atlantic had the right, in case of default, at the dates stipulated in the contract, to take possession of its property and manage it until its debt was paid. Superior felt the need of buying more oil property to increase its production and to increase its working capital. Nor could Superior increase its stock to accomplish these objects, for the contract provided "that, so long as any part of said loan of $2,750,000 and interest remains unpaid, the capital stock of Superior shall not be increased." The only way it could pay off its creditor was to induce Atlantic to convert its debt into stock. On the other hand, the bankers who would underwrite the stock would not do so unless Atlantic did three things: First, undertake the management of Superior; second, agree to take for 10 years, at market prices, Superior's entire present and to be acquired oil production; and third, tie up the bought Superior stock for two years. Under such circumstances, and in view of the fact that the bankers would not underwrite the issue unless these conditions were complied with, it is clear

that the sale of stock to Atlantic at $8 secured for Superior the $16 from the bankers, and that the making of such sales at different prices was within the field of business discretion vested in the board of Superior's directors, under the quoted decisions of the Court of Chancery, provided, of course, they acted in good faith. * * *

Taking up seriatim these alleged elements of fraud, we are clear that the issue or sale of this $8 stock by Superior was legal under the Delaware law. The stock was no par stock; it was not a sale or issue under par, for example, not the case of a sale at $8 for a stock of a greater par value; and under Delaware corporate law $8 was a legal basis which justified its issue. Its sale at $8 being justified, the further question arises: Was the $8 stock illegal, because stock of the same issue was, by the same general transaction, sold at the same time to others at $16? As we have seen elsewhere, sales made at different prices are lawful under Delaware law, if made by the company for fair and adequate business and administrative reasons. Such being the fact in this case, the first alleged ground of fraud fails, unless Superior was deceived and misled into the belief that, by its contract of August, Atlantic was paying $16 a share for its stock; in other words, that, instead of being paid by Atlantic $2,750,000 for its stock, it was being paid $5,500,000. * * *

On the part of Atlantic, that company burdened itself by contracting to handle the entire product of Superior for 10 years; by contracting to buy and handle that product when oil was at low figures and a drug on the market, and in point of fact oil which was at a peak price of over $4 per barrel when the August 1920, contract was made had fallen to somewhat over $2 just before this bill was filed; by assuming the whole management of Superior when it only owned one-third of its stock; by changing its position of creditor with assured periodic interest payments for that of stockholder with uncertain dividends; by tying up its stock for 2 years as that stock which others, during the tie-up period sold for $16, and indeed as high as $20.75 had only a value of some $6 when the tie-up expired. On the other hand, by these contracts, Superior got the money to pay off all its indebtedness, enable the bankers to sell its stock, and obtained working capital and funds to buy additional property. * * *

Decree reversed and bill dismissed.[53]

BODELL v. GENERAL GAS & ELECTRIC CORPORATION.

Court of Chancery of Delaware, 1926. 15 Del.Ch. 119, 132 A. 442.

Bill for injunction by Joseph J. Bodell and others against the General Gas & Electric Corporation to restrain the issuance of shares of stock. Rule discharged, and restraining order vacated.

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53 Certiorari denied 273 U.S. 731, 47 S.Ct. 240, 71 L.Ed. 863, 1926.

The issuance of shares to bankers and promoters for corporate organization and reorganization is dealt with by Berle, Compensation of Bankers and Promoters Through Stock Profits 1929, 42 Harv.L.Rev. 748. See, also pp. 66 to 67, *supra*.

Injunction bill to restrain the issuance of shares of stock at twenty-five dollars a share to the extent of a quarterly dividend declared by the defendant upon its Class A common stock.

The defendant was organized July 15, 1925, for the purpose of taking over and refinancing two then existing public utility corporations organized under the laws of the State of Maine. The authorized capital stock of the defendant consists of 1,700,000 shares divided into two classes, preferred and common, all without nominal or par value. The authorized preferred is 500,000 shares. It is divided into two classes, each of which is entitled to a fixed cumulative dividend in dollars. The preferred stock is not concerned in this litigation and detailed description of its rights is not therefore called for.

The authorized number of common shares is 1,200,000 divided into 800,000 shares of Class A common stock, and 400,000 shares of Class B common stock. In addition to these stock provisions, the certificate of incorporation creates what is called 380,600 Dividend Participations.

The Complainants in the suit are holders of both class A and Class B common stock. They complain however in their character of Class B common stockholders.

In addition to about 135,000 shares of preferred stock of both classes outstanding, the corporation has issued 303,004.5 shares of its common stock, Class A, 203,888.4 shares of its common stock, Class B, and 379,332.8 Dividend Participations. Its preferred and common shares are traded in on the New York Stock Exchange.

The rights of the common stocks and the Dividend Participations are defined to be as follows: After the preferred dividends are provided for, the Class A Common Stock shall receive a dividend (non-cumulative) at the rate of $1.50 per annum, then the common stock, Class B, is entitled to receive a like dividend of $1.50 per annum, and in the case dividends are further declared from surplus of net profits Class A common, Class B common and the dividend participations are entitled to share equally therein.

Upon liquidation, the preferred stocks are preferred over all other classes to the extent of one hundred dollars per share plus accumulated and unpaid dividends thereon. Subject to such preference, Class A common is preferred over Class B common to the extent of twenty-five dollars per share, then Class B common receives twenty-five dollars per share, and thereafter any remaining assets are distributable between Classes A and B common in equal amounts. Upon liquidation the dividend participations receive nothing.

All quarterly dividends on the preferred stocks have been declared and paid to date.

When the corporation was formed, the Class A common stock was the particular stock from the sale of which its organizers planned to realize its principal financial requirements as occasion should arise from time to time. The business of the corporation being in the public utility field, it was anticipated that the need of additional funds would frequently be felt in the course of the development of its present properties and in the acquisition of new ones. Accordingly, the defendant in its answer avers that it was desired to make the Class A common stock

attractive to the investing public. The original sale of this stock was of a block of 120,000 shares to bankers who, the answer avers, and the affidavit show, were informed by the offering corporation that dividends would commence on said stock at the next dividend date fixed therefor at the rate of $1.50 per annum and that the corporation would offer to the holders of said Class A common stock the right to subscribe to stock of the same class at twenty-five dollars per share to the extent of the dividend. This right to subscribe is claimed to have had the effect of making the Class A common stock highly attractive to investors, so much so that the corporation has been able to receive for all of its Class A common stock originally and subsequently issued an average of nearly forty-two dollars per share and the market price of the stock has ranged between fifty dollars and sixty-four dollars per share. On July 16, 1925, the corporation agreed with the bankers that the first dividend on Class A stock might be used to subscribe for Class A stock at twenty-five dollars a share, as before stated. An announcement to this effect was made by publication in leading newspapers once in August, 1925, and four times in September.

The first dividend date was October 1, 1925. The holders of Class A common stock were advised by letter that they might subscribe for stock of the same kind at twenty-five dollars per share to the extent of their dividends, provided subscriptions were received by the transfer agent on or before September 21, 1925. In the absence of subscription, the letter said that the dividend would be paid in cash.

Complainants were holders of Class A common stock and elected to exercise their option to use their dividends in payment for further stock at the price named in the letter. A total of 2,003 shares of Class A common stock was issued to stockholders in exercise of their options under the October 1 dividend declaration.

On September 30, 1925, the officers of the corporation notified the bankers that in their opinion the policy adopted by the directors of allowing owners of common stock Class A to have the privilege of investing their regular dividends in additional Class A common stock at twenty-five dollars per share, was in the interest of the corporation and one that should be continued.

On November 4, 1925, the directors resolved to issue more of the Class A common stock, and to give to stockholders of all classes the right to subscribe therefor at forty-five dollars per share on the basis of one share for each ten shares held at the close of business on November 20, 1925.

On November 11, 1925, an offer was made to all classes of stockholders in accordance with the resolution of November 4. About 48,000 shares were subscribed for in response to this offer and in due course issued. The offering letter contained the two following paragraphs which because of their importance are quoted in full:

"It is also the intention of the corporation to offer to the holders of its common stock, Class A, who shall be entitled to the dividend payable January 2, 1926, the right to subscribe to additional shares of common stock, Class A, to the amount of the dividends to which they are so entitled at the price of twenty-five (25) dollars per share, and ar-

rangements will be made with the transfer agent so that the stock applicable to such dividend will be forwarded to the stockholder in lieu of the cash, unless the transfer agent is notified to the contrary.

"The officers and directors of the corporation believe that this policy of offering the right to subscribe to the extent of the dividends of this stock should be continued unless some change in business or financial conditions requires its modification or abandonment."

The declared intention contained in the foregoing letter was followed by a resolution adopted on December 4, 1925, by which a quarterly dividend of thirty-seven and one-half cents a share was declared on the Class A common stock payable on January 2, 1926, and stockholders were given the right to use their dividends in payment for additional shares of the same stock at twenty-five dollars per share to the extent of their dividends. Class A common stockholders were by letter dated the same day notified of the declaration of this dividend. The letter so notifying them contained the following paragraph:

"Holders of common stock, Class A, are given the right to subscribe to additional shares of common stock, Class A, of this corporation at the price of $25.00 per share to the extent of the dividends payable to them on January 2, 1926. The Equitable Trust Company of New York, transfer agent, will deliver to each of the holders of common stock, Class A, entitled to the dividend payable January 2, 1926, common stock, Class A, or scrip certificates therefor, equivalent in amount, taken at $25.00 per share, to the number of dollars of dividends to which each such stockholder would be entitled, unless advised by such stockholder on or before December 21, 1925, that such stockholder does not exercise the right of subscription to which he is entitled and requests the payment of the dividend in cash."

In response to this offering something like 4,310 shares of common stock, Class A, were subscribed, but their issuance was restrained by order of the Chancellor upon the filing of the bill and pending a hearing on a rule for preliminary injunction.

On December 4, 1925, the book value of Class A common stock is admitted to be over twenty-five dollars per share—how much over twenty-five dollars per share is not stated. Class A common stock has been traded in, first on the New York Curb and since on the New York Stock Exchange. Its price since the incorporation of the defendant in July, 1925, down to January 18, 1926, as shown by market quotations has ranged from a low of about fifty dollars to a high of sixty-four dollars, and on the last mentioned date was about fifty-eight dollars per share. The current quotation is now shown to be about forty-eight dollars per share.

No charge of personal gain or fraud of any kind is made against the directors. They are owners of Class B common stock. None of them is interested in Class A common except to the extent of twenty-five shares owned by one director.

The bill was filed on December 23, 1925. It seeks particularly to enjoin the corporation from carrying out its notified intention of allowing the holders of the Class A common stock to receive additional shares of Class A common at the rate of twenty-five dollars per share

to the extent of their dividends; and generally to enjoin the defendant from issuing to the holders of its common stock, Class A, additional shares of such stock at less than the fair value thereof, unless there shall have been paid or set apart for payment, to the holders of common stock, Class B, during any calendar year, dividends at the rate of $1.50 per share per annum, and unless such additional shares are issued to holders of said common stock, Class B, upon the same terms as they are issued to the holders of common stock, Class A.

Upon the filing of the bill a rule to show cause why a preliminary injunction should not issue enjoining the defendant from issuing Class A common stock to holders of that class of stock at twenty-five dollars per share to the extent of their dividends, as it was the declared intention of the corporation to do. A temporary restraining order to like effect was issued.

The rule to show cause now came on to be heard upon bill, answer and affidavits.

THE CHANCELLOR. The complainants state their contention in this case under two heads. They are, (a) the practice complained of constitutes a conscious offer of no par value stock below its fair sales value, and, like all such offers, is illegal; and (b) even if a conscious offer of no par value stock below its fair sales value may be legal if made to certain persons, it is illegal if made to the A stockholders alone in addition to their quarterly cash dividends of thirty-seven and one-half cents per share and before the B stockholders have received $1.50 per share. No attempt will be made in the ensuing opinion to divide the discussion into two parts corresponding to the two headings. The general discussion which follows will, however, disclose my views upon both branches of the argument.

The principal statutory provision with which we are concerned in this case is found in section 4a of the General Corporation Law [34 Del.Laws, c. 112]. That provision is, as follows:

"Such capital stock without nominal or par value * * * may be issued by the corporation from time to time for such consideration as may be fixed from time to time by the board of directors thereof, pursuant to authority conferred in the certificate of incorporation or in any amendment thereof, or if such certificate or amendment thereof shall not so provide, then by the consent of the holders of two-thirds of each class of stock then outstanding," etc.[54]

This language appears in the section authorizing the creation of stock without nominal or par value, which section was first adopted as a part of the Corporation Law by the act approved March 20, 1917 (29 Del.Laws, c. 113). By this act, the plan of no par stock was permitted with respect to common stock only. Now, however, by virtue of an amendment approved April 2, 1925 (34 Del.Laws, c. 112), no par stock is allowed as well with respect to preferred stock. The quoted language, whether the stock be an issue of common or of preferred, is applicable.

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[54] *Cf.* Del.Rev.Code 1935, § 14.

Here we are not concerned with any question relating to the two classes of preferred stocks of this corporation. The controversy has solely to do with the right of the directors to issue no par common stock A to present holders of that stock, for the consideration of twenty-five dollars per share to the extent of their dividends while at practically the same time they offer to sell and succeed in selling to all other classes of stockholders, or in the alternative to underwriting bankers, a much larger number of shares of the same kind of stock at forty-five dollars per share.

The certificate of incorporation confers upon the directors authority to issue the stock. The provision in the quoted language concerning the necessity of consent on the part of two-thirds of its stockholders is therefore not involved in the case.

Nor is the general preemptive right of stockholders to subscribe for stock involved in the consideration of the case. The complainants in their reply brief concede this.

Stock without nominal or par value, though not a new feature in corporate structures, has had a distinct revival in recent times. Until a few years ago, capital shares were almost invariably, if not entirely, associated in this country with the conception of a par value expressed in dollars. When the plan of issuing shares without nominal or par value was adopted by this and other states, it was certainly intended by the legislative authority to introduce into the characteristics of such stock qualities which capital stock, in the theretofore existing conception of the term did not possess. Our Superior Court in State ex rel. Radio Corporation of America v. Benson, 2 W.W.Harr. 576, 128 A. 107 observed that "shares of no par stock represent aliquot or proportionate parts of the capital." This same statment might also be made of shares having a par value. What the Superior Court meant to emphasize by the quoted language doubtless was, not that no par shares were in the particular of proportionate ownership distinguishable from shares having a par, but that with respect to this feature the no par shares on their face, unlike par value stock, contained no reference to a dollar value. Thus the holder of no par shares would see from the certificate itself that he was only an aliquot sharer in the assets of the corporation, whereas if the shares were of the par value type the holder might in looking at the dollar value be beguiled into the thought that what he had was shares of actual value equal at least to the par denomination in dollars. Upon the feature now being considered, the difference between stock of a par value and of no par value, upon analysis consists not in a difference with respect to a proportionate or aliquot share in the corporation's assets and business, but in the fact that in the case of the latter this character of proportionate interest is not hidden beneath a false appearance of a given sum in money. It is of course common knowledge that though a stock may have a par value of one hundred dollars, it may, because of its aliquot nature, be worth that, or more, or less, dependent upon the value of the entire assets of the company. The frankness of no par value shares in claiming nothing more for themselves than an aliquot share of the assets without reference to a dollar value, is one of the things that has

commended them to the favorable notice of their advocates. But this particular difference between the modern no par stock and its companion, the par value stock, is not of particular moment here.

Another difference between the two, which is more to the point in the instant case and of quite vital interest in considering the question of law with which we are here concerned, has to do with the consideration which is required to be exacted by the corporation for the issuance of its stock. The introduction into our law of stock without par value has not of course resulted in allowing a different kind of consideration to be received for it from that which has heretofore been required for par value stock. In other words, whether the stock have a par value or none, it still remains true that—

"No corporation shall issue stock, except for money paid, labor done or personal property, or real estate or leases thereof actually acquired by such corporation." Article 9, § 3, Constitution of Delaware.

As to the kind or quality of consideration for which stock may be issued, no par stock is in exactly the same situation as is stock having a par value.

But upon the point of amount of consideration, there is a distinct and pronounced difference between the two. With respect to par value stock the law sets up a standard in dollars with which the consideration given must square itself. That standard is of course the par value of the shares issued. It is this feature of par stock which, more than the other one of lack of frankness above referred to, served doubtless to induce those interested in corporate activities to advocate the idea of stock without nominal or par value. The manifest danger of an overvaluation of assets given in exchange for par value stock and the risk of liability consequent thereon in the cases of both new and going concerns, and the rigid strait-jacket into which corporate financing by sales of stock of a going concern was placed if the actual value of its stock had fallen below par, were the prime considerations which prompted corporate organizers and managers to evolve some plan for stock issues which would liberate shares of stock from the thraldom of the par value feature. Whether the reasons advanced were sound ones and well-grounded in a wise public policy is not for me to say. The fact is that they prevailed with the Legislature of our State and now find the object which they were advanced to promote embodied principally in section 4a of our General Corporation Law.

That section does not set up a par value standard to which issues of stock authorized by it must comply. While the section does not attempt the vain thing of disturbing the constitutional requirement as to the kind and quality of consideration which must be given for stock, it does destroy absolutely the quantity of consideration which must underlie the shares of stock authorized to be created. Not more than one hundred shares of stock having a par of one hundred dollars can be issued for ten thousand dollars worth of consideration. But for the same amount of consideration any number of no par value shares may be issued. So far as the amount of consideration any number of no par value shares may be issued. So far as the amount of consideration is concerned it may be run out to an infinitesimal sum under each

no par share. This is the literal meaning of the section. All the directors have to do, if they are given the power as they were here, is to fix the consideration. Its amount is of no moment. So far as the literal language of the section is concerned, the directors may from time to time issue no par stock for any consideration they may see fit, even though the price they fix is far below its actual value. For instance, if the outstanding no par stock is actually and demonstrably worth three hundred dollars a share, there is nothing in the statute which would prevent the directors from issuing additional stock to outsiders at ten dollars per share. What I am now pointing out is simply this—that the statute does not impose any restraint upon the apparently unbridled power of the directors. Whether equity will, in accordance with the principles which prompt it to restrain an abuse of powers granted in absolute terms, lay its restraining hand upon the directors in case of an abuse of this absolute power, is another question which will be presently considered and answered in the affirmative.

Just now I am endeavoring to point out that the section which deals with no par stock furnishes no yardstick, as in the case of par value stock, by which the amount of the consideration is to be measured. It does not substitute for the standard of a par value another standard, for instance, a real, or market, or book value. When, therefore, the complainants object that what the directors did in this case "constitutes a conscious offer of no par value stock below its fair sales value, and, like all such offers, is illegal," they cannot point to any language in the statute upon which to hinge their objection. The statute makes no mention of "sales value," or of any other similar thing to which no par stock issues must conform themselves.

But notwithstanding the absolute character of the language in which the power to the directors is expressed, it cannot be that a court of equity is powerless in proper cases to circumscribe it. The section requires the directors to fix the consideration. It certainly would be out of all reason to say that no court could review their action in fixing it. I do not understand the defendants to argue that the action of the directors in this particular is not reviewable. They do insist, however, that inasmuch as the matter of the issuance of the stock was placed by the certificate of incorporation in their control, the general principle which excludes stockholders from matters of management and accords to the acts of the directors a presumption in favor of their propriety and fairness, is to be here applied. This is true.[55]

There is no rule better settled in the law of corporations than that directors in their conduct of the corporation stand in the situation of fiduciaries. While they are not trustees in the strict sense of the term, yet for convenience they have often been described as such.[56] With respect to the unissued stock, they are said to control it as trustees. With respect to par value stock their duty is to authorize its issuance only for property equalling its full par value. But stock of the kind

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55 See, Berle, Non Voting Stock and "Bankers Control", 1926, 39 Harv.L.Rev. 673.

56 See, Note, The Director of a Corporation as a Fiduciary, 1935, 20 Iowa L.Rev. 808.

here involved has no par value. What consideration should the directors demand for its sale? In answering this question, it would seem that the answer should turn very largely upon the stage of the corporation's development at the time of the issuance.

If the corporation has just been formed, I do not see that it can make any difference how much or how little in the way of a consideration is received for its original no par stock, so long as the consideration is lawful in its quality. If the assets received are one thousand dollars in money, it is of no consequence whether five shares or ten shares, or ten thousand shares are given for it. Each share has its one-fifth or one-tenth or one-thousandth aliquot part of the thousand dollars as the case may be, and no one is damaged because everyone knows that under each share is simply its proportionate part of the total assets, unexpressed in terms of money.

But suppose after the corporation has been in business for some time and has built up a surplus above the assets originally received, then it is apparent that the price at which additional stock is issued does have a very material effect on the interests of the existing shareholders. If it is now desired to raise more capital by the sale of new shares, it is manifest that inasmuch as a new divisor for the total assets is to be found, it becomes of vital interest to the existing stockholders to see to it that the value of the fraction representing the present aliquot interest in the assets held by each is not diminished. This interest is so vital that courts have in other connections regarded it as an equity entitled to protection against action which threatens its impairment. It is the consideration, for instance, together with the equity that demands a preservation of the proportionate voting power in a corporation, upon which is founded the doctrine of the stockholder's preemptive right to subscribe for stock.[57] Gray v. President, etc., of Portland Bank, 3 Mass. 364, 3 Am.Dec. 156; Wall v. Utah Copper Co., 70 N.J.Eq. 17, 62 A. 533; Stokes v. Continental Trust Co., 186 N.Y. 285, 78 N.E. 1090, 12 L.R.A.N.S., 969, 9 Ann.Cas. 738. If new shares of a going corporation are to be sold and the price per share is less than the present value of each aliquot interest, and if the new shares go to outsiders or to a selected group of outsiders, those stockholders who are not permitted to subscribe are bound to suffer a diminution of the value of each proportionate interest held by them, unless they are allowed to take their proportionate part of the new shares. The doctrine of preemptive right has therefore been erected by equity for their protection in this regard. Nor does the fact that earnings have not yet accumulated alter the situation with respect to this doctrine, for as said by the courts in the cases just cited a shareholder's interest is confined not alone to present, but as well to anticipated increases in its earnings.

Notwithstanding therefore the absolute terms in which the power of the directors of this corporation to fix the price at which its unissued stock may be sold is expressed, equity will nevertheless by an analogy to that reasoning which underlies the doctrine of preemptive right interfere to protect existing stockholders from an unjustified im-

57 See, pp. 332 to 355, *infra*, on stockholders' preemptive rights.

pairment of the values underlying their present holdings, where it is proposed by the directors to fix the consideration for new shares of the no par value type. The power of the court to interfere, however, must be exercised in accordance with general equitable considerations, for the justification for its interference rests not on statutory provisions, but upon its broad equitable power to protect against wrongs. Take the glaring case put a moment ago, of a proposed sale by directors of stock of ten dollars a share which is demonstrably worth three hundred dollars a share. Surely no court on that bald showing of facts would allow the transaction to proceed. There could be no semblance of right in thus offering to others an equal equitable share in the assets belonging to existing stockholders without paying fairly therefor.

Nor do I think that if the directors propose to sell stock to some persons at twenty-five dollars a share and at the same time are successfully marketing a much larger block of the same stock at forty-five dollars a share, the transaction on that bare showing can in the absence of satisfactory explanation stand, for common sense would suggest that if a large quantity could be made to produce forty-five dollars a share a smaller quantity ought not to be regarded as productive of only a possible twenty-five dollars a share. As before stated, directors are regarded as trustees in the matter of the disposal of unissued stock. It is not always necessary for them to reap a personal profit or gain a personal advantage in order for their actions in performance of their quasi trust to be successfully questioned. Trustees owe not alone the duty to refrain from profiting themselves at the expense of their beneficiaries. They owe the duty of saving their beneficiaries from loss. Cahall v. Burbage, 14 Del.Ch. 55, 121 A. 646; Allied Chemical & Dye Corporation v. Steel & Tube Co. of America, 14 Del.Ch. 1, 120 A. 486; Id., 14 Del.Ch. 64, 122 A. 142. And so here, if the sale of this stock to the Class A common stockholders at twenty-five dollars per share to the extent of their dividends (it would take about 4,000 shares) works out an injury to the holders of Class B common, the fact that the directors are gaining no advantage thereby is immaterial.

The complainants are necessarily resting their case on an equity which they erect and seek to impose on the statutory power of the directors. The equity is founded on the principles of fairness. If what is proposed to be done, however, is in fact not unfair nor unjust to the complainants, they cannot successfully claim relief. The cases which find an exception to the application of the doctrine of the stockholder's preemptive right to subscribe when no injury is seen, show that when the element of unfairness is absent, the doctrine is inapplicable. This but emphasizes the fact that questions of the type we are here considering are thrown into the broad general field of fair and just dealing, and are to be answered by equity in the light of those conceptions by which the acts of men are appraised as fair and just or otherwise.

The mere showing of the two prices would without satisfactory explanation undoubtedly entitle the complainants to relief. But if these two prices are justified by showing of fairness in the light of all the circumstances so that what appears to be an injury turns out to be a benefit to those complaining, there can be no ground for interference. If

the directors, in the course they are pursuing are acting in the genuine and beneficial interest of the corporation and are thereby promoting the interests of all stockholders in a very tangible way and especially the interests of the class of stockholders who are complaining, why should not the general principles applicable to persons standing in trust relationships come to their supporting aid?

The injury which the complainants point out consists in this. They contend first that if a sales price for Class A common stock is established by sales at forty-five dollars, such price is the sum which directors must demand for all stock concurrently offered. Class B common is junior to Class A common both with respect to dividends and on liquidation. If less is realized for Class A than is fairly obtainable it is manifest, say the complainants, that less capital is brought in than would otherwise be possible and so Class B common would suffer in that less earnings would accrue from which Class B might hope for its junior dividend rights to be taken care of, and on liquidation less capital would be on hand for distribution and the amounts distributable to it thereby diminished. This in the main is the line of argument by which the complainants as holders of Class B Common stock seek to establish the injury which is done to their equity in this corporation.

Now on the other hand, the defendants point out that the policy heretofore adopted and proposed to be continued until conditions warrant a change, of allowing Class A common stock dividends to be used in subscribing for further stock at twenty-five dollars per share, has been the very thing which has enabled the corporation to sell its Class A common stock in large blocks at forty-five dollars a share and has caused it to sell on the exchange for from fifty dollars to sixty-four dollars a share. It has had this result they say for the following reasons. Class A common stock is entitled to a dividend of $1.50 a year ahead of Class B. This dividend in not cumulative. Class A common also has a right to further dividends equally with Class B common after the latter is paid $1.50 a year. It of course still had and has a prospective right to further possible dividend declarations. But these lie in the realm of possibilities, which are dependent upon earnings. The problem which the directors had before them was to induce the public to buy the Class A common at as high a figure as they thought could possibly be obtained. They fixed forty-five dollars a share as the price they thought they could obtain. Bankers were called in to make a market for the stock at that figure. They did so, selling 120,000 shares upon the organization of the company. The public was told that the first dividend could be used in buying further stock at twenty-five dollars a share. The stock which was thus sold at forty-five dollars was regarded by the purchasing public as yielding an immediate return of only $1.50 a year. That would be six per cent. on twenty-five dollars and only three and one-third per cent. on forty-five dollars, the price paid. Something, it is argued, must have been offered as an inducement to the public to persuade it to invest money on a three and one-third per cent. basis. The directors and bankers thought that the right to use dividends in further subscriptions at twenty-five dollars per share would supply the additional

something to induce the investing public to buy. At at all events by the exercise of those methods which investment bankers are versed in, the stock was sold and at the same time, by those methods which investment bankers again are skilled in employing, the market quotations of the stock showed prices ranging from fifty dollars to sixty-four dollars per share. Thus the right to subscribe dividends for stock at twenty-five dollars per share held out the prospect to the stockholders on the basis of the issuing price of forty-five dollars a share, of making a profit of twenty dollars a share on the stock taken for dividends in case it was desired to sell it. The bankers of course played up this feature in marketing the stock and by their operations on the exchange created a price which subsequently made the prospect of profit even more inviting.

Now when it was desired to sell 48,000 more shares of Class A common, it was announced that the right to use dividends in subscribing for further shares of the same kind at twenty-five dollars would continue as a policy. This policy it is claimed made the sale of the additional stock an easy matter, for in addition to the regular dividend of $1.50 a year which the stock was paying, the announced policy held out to purchasers the prospect, just referred to, of making a profit on the stock they might take at twenty-five dollars for their regular dividends. Thus, to use an old expression, the stock lifted itself by its own bootstraps. If the value of forty-five dollars per share is thus created by the combined action of the announced policy and the creation of market prices by the sustaining operations of the bankers on the exchange, it is manifest that forty-five dollars, the price which was concurrently obtained by the corporation when it was announced that Class A dividends would be allowed to buy it at twenty-five dollars per share, does not represent a sales price which the directors can in fairness be held to. It would be highly unreasonable to point to sales at forty-five dollars as showing the inadequacy of sales at twenty-five dollars if the latter was what in fact made the former possible.

It is difficult of course for any one to measure in exact dollars the extent to which the announced policy has contributed to the price of forty-five dollars as well as to the market prices of this stock. That it had weight I have no doubt. The quotations of prices for certain insurance company stocks at figures far in excess of the usual investment bases, show how rights to take stock may contribute to market values. So, also, doubtless, is the market price of American Telephone & Telegraph Company's stock affected by the practice of that corporation in selling its new issues to stockholders at par. That the directors of the defendant company honestly believed that their policy of allowing Class A common dividends to be used to purchase further stock at twenty-five dollars a share would make a highly favorable price for that stock, the stock to which they looked for additional corporate funds, and more of which the development plans would require to be marketed, is not on the present showing to be doubted. A complete absence of selfish motive and of personal profit on their part forcefully argues that their judgment was formed in absolute honesty

and entire good faith. If, as a result of the policy thus grounded, the corporation is able to secure funds from stock sales greatly in excess of the amount they otherwise could hope to realize, it is manifest that an advantage has been secured for the corporation and for all its stockholders. The directors take the view as disclosed by the answer and affidavits that the announced policy has in fact yielded such advantage in an exceedingly large amount. They think that if it were not for the policy in question the block of 48,000 shares recently sold would not have been marketed at much if any above twenty-five dollars per share. It is of course a difficult matter to market a quantity of stock of that volume. It would be fatuous to expect to get the quoted exchange price of fifty dollars or sixty-four dollars a share for it by the simple process of offering it for sale on the stock exchange. Such an offering would have caused the market in the stock to crash beneath its weight and in the end would have resulted in a sacrifice of the offered shares. Now in this situation it does not seem fair to say that the course the directors pursued did not result in securing a price substantially above, possibly twenty dollars a share above, the price which but for such policy could otherwise have been obtained. It being a matter appropriately lying within the field of that discretion which directors are recognized to control, I do not feel disposed in the absence of a showing of improper motive to assume to interfere with it.

What has been the result of this piece of financing? It is this—48,000 shares have been sold at forty-five dollars, and as a contributing cause making that price possible only 4,003 shares have been offered at twenty-five dollars. From the viewpoint of the Class A common stock, Class A shares which have a prior charge of $1.50 a year, or six per cent. on twenty-five dollars, have been placed at forty-five dollars a share. This corporation's money earns eight per cent. so the affidavits show. For each forty-five dollars received, therefore, the corporate treasury will annually earn $3.60 which after deducting the prior $1.50 per year on the Class A common which was sold leaves $2.10 a year available for the $1.50 a year dividend on Class B. To the extent that the absence of the policy referred to would result in reducing the obtainable price for the Class A stock below forty-five dollars, the benefit to Class B would be correspondingly reduced. Furthermore, in case of dissolution the price of forty-five dollars leaves twenty dollars for the Class B stock after paying Class A its liquidation value of twenty-five dollars. Thus again, to the extent that the forty-five dollar price is due to the policy referred to, Class B is benefited. It is to be noted also that the stock taken by the Class A dividends is required to pay a per share price which is equal to its own prior liquidation charge in case of dissolution, and in the meantime will at the eight per cent. rate of earnings yield fifty cents a year more than its own annual dividend requirement of $1.50. I do not pretend to say by what precise amount Class B common stock has been benefited by the policy of allowing Class A common stock to use its dividends in purchases at twenty-five dollars. That it has been considerably benefited, I cannot doubt on the showing made. The benefit may or may not have been to the extent of twenty dollars for every share sold as believed by the

defendants. That is a matter of opinion, and there is no good reason shown why this court should upon that matter of opinion reject the judgment of the directors as unsound.

The equity upon which the complainants rely is founded on the conception that an injury is done them. If no injury appears, no equity exists. On the showing made it seems that instead of an injury a benefit has been conferred. While it has nothing to do with the merits of the cause, yet it is interesting to note that the directors themselves own no Class A common stock but do own about two-thirds of the common stock Class B, and if wrong is done to that class of stock the directors who have done it have visited most of its consequences upon themselves.

There remain a few observations to be made with respect to some of the contentions advanced at the argument and not before commented upon. Not only did the complainants point to the concurrent price of forty-five dollars per share received for Class A common stock, but they also pointed to the market range of from fifty dollars to sixty-four dollars on the New York Stock Exchange and the admission in the answer that the book value is above twenty-five dollars a share, as showing the fair value which the directors in exercising their duty of marketing new stock ought to have demanded. I have already tried to show why the forty-five dollar figure is an unsafe guide. So also is the figure indicated by market quotations. This is so for two reasons—first, because you cannot hope to dump large quantities of stock into an open market and expect to receive current prices therefor, and second, because there is no reliability to be placed in market quotations as showing true value. The case of Hodgman v. Atlantic Refining Co., D.C., 300 F. 590; Id., D.C., 2 F.2d 893, is cited in support of the proposition that the market value of stock is a proper criterion to accept as the price at which directors ought to issue similar stock. The case does not so hold. Market value was referred to in that case for the purpose of measuring damages and no more. That is an entirely different proposition from that with which we are here concerned. As market value cannot be accepted as a safe guide for the fixing of the sales value for unissued stock, so also neither can book value in itself be so accepted. A study of the quoted market values of stocks and their book values will disclose strange and striking inconsistencies in their relations to each other when the issues of various corporations are comparatively examined. We may accept the general proposition that managers of corporations ought to be required to market new issues of no par stock at prices that are fair to the corporation and existing stockholders and best calculated to yield the largest possible capital. These prices should be fixed in the light of all legitimate considerations such as appraised and sale value of assets, book values, market values of outstanding shares, present and probable earning power, market conditions, size of the issue, reputation of the corporation, and such exceptional considerations as honest and fair minded men might properly take into account. It would be hazardous to venture an examination of all the possible considerations which directors might take into account in fixing a price which will be fair to the corporation and

its existing stockholders and best calculated to yield the largest possible capital. Whether in a given case they have fixed such price is a question which must be determined in the light of the particular conditions surrounding the transaction. Enough appears in this case to take from the transaction the appearance of unwarranted and unfair conduct which the sale of stock at the same time at two different prices would in the absence of explanation fasten upon it.

The complainants argued also that allowing the Class A common stockholders to use dividends in buying other Class A stock at twenty-five dollars a share amounts to a declaration of a dividend to them over and above the preference which the certificate of incorporation of the company allows as against the Class B common. I confess I cannot follow that argument. It seems to turn on the thought that the purchased shares can in turn be sold on the market at a profit above twenty-five dollars a share and thus the Class A common stockholder can realize out of his dividend of $1.50 a year more than that sum. The obvious answer to that is that while to be sure a profit can thus be made and the Class A stockholder obtain more than his dividend of $1.50 a year, the additional sum is not taken out of the earnings of the company. It is derived from the man to whom the stock is sold on the market. The question here is not one of dividends. It is one of capital —whether the directors are securing as much capital from the sale of stock as they ought to secure. That question I have already discussed.

The complainants make the further point that if the directors allowed the desire to create a forty-five dollar market for 48,000 shares to influence them in offering stock to Class A common stockholders at twenty-five dollars a share, then they permitted as an element of the consideration which the company was receiving for the latter something which is neither "money paid, labor done or personal property, or real estate or leases thereof actually acquired by the corporation," and so have admitted into the consideration for the stock something which lacks the quality of lawful consideration. This, however, appears to me to be fallacious. It is incorrect to describe this "something" as a part of the consideration. It was not a thing given by the subscriber for the twenty-five dollar stock. For that stock, twenty-five dollars and no more was the consideration given by the subscriber. This was "money paid," a lawful consideration. The other circumstance, the "something" referred to, was simply the reason and explanation for fixing the twenty-five dollar consideration in that amount.

The statute in section 4a provides that when the directors have the power to issue no par stock it—

"may be issued * * * from time to time for such consideration as may be fixed from time to time by the board of directors."

I do not recall that any special emphasis was laid by the complainants at the argument on the phrase "from time to time" as of significance in the instant case. Here of course the two offerings were concurrent. In substance there was no interval of time between them. But this is of no moment. Prices at which no par stock is issued cannot be made to depend for their fairness upon the immaterial circumstance of the length of time intervening between the moments of their

issuance. The phrase "from time to time" gives to the section this meaning—that no par stock may be issued at any time for such consideration as may be fixed by the directors at the time the issue is authorized.

An order will be entered discharging the present rule and vacating the outstanding restraining order. The conclusion herein reached is of course based on the present showing. What sort of case changed or added circumstances might present in the future would have to be answered in the light of the showing then presented in case challenge should be made of the propriety of the directors' action.[58]

NOTE

"Some possible objections to no-par stock which need more careful attention than the present laws give, are: First, the ease of inflation and the danger of manipulation by issuing large amounts of stock for property of little value; Second, the possibility of frauds on investors by diluting the stock already issued by subsequent issues at lower prices; theoretically the subscription price of the stock should be uniform and equal; at least in the beginning the subscriber should have some assurance that others will not pay less than he is required to pay; Third, the absence of any convenient basis of taxation for organization and franchise taxes[59]; Fourth, the lack of sufficient protection to creditors, only a small amount of capital usually being required to be paid in as a basis of financial responsibility at the start, with no provision for increase later." Ballantine, Stockholders' Lia-

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58 Aff'd, 15 Del.Ch. 420, 140 A. 264, 1927; Masterson, Consideration for Non Par Shares and Liability of Subscribers and Stockholders, 1939, 17 Tex.L.Rev. 247, 282; 1926, 26 Col.L.Rev. 893.

The three preceding principal cases are considered by Wickersham, Stock without Par Value, 1927, 83–92.

For a discussion of the rights of holders of non-par stock to subscribe to a new issue of shares, see Berle, Problems of Non Par Stock, 1925, 25 Col.L.Rev. 43, 56.

59 54 Stat. 522, 26 U.S.C.A. Int.Rev.Code, § 1802: "*Capital stock (and similar interests)* (a) *Original issue.* On each original issue, * * * of shares or certificates of stock * * * by any corporation * * * where such shares or certificates are issued without par or face value, the tax shall be 10 cents until July 1, 1945, and 5 cents thereafter, per share * * * unless the actual value is in excess of $100 per share; in which case the tax shall be 10 cents until July 1, 1945 and 5 cents thereafter, on each $100 of actual value or fraction thereof * * * or unless the actual value is less than $100 per share, in which case the tax shall be 2 cents until July 1, 1945, and 1 cent thereafter, on each $20 of actual value, or fraction thereof, of such certificates * * *

(b) *Sales and transfers.* On all sales, or agreements to sell, * * * when such shares or certificates are without par or face value, the tax shall be 4 cents until July 1, 1945, and 2 cents thereafter, on the transfer or sale or agreement to sell on each share * * * Provided, That in case the selling price, if any, is $20 or more per share the above rate shall be 5 cents instead of 4 cents until July 1, 1945 * * *"

N.Y.Tax Law, § 180: "*Organization Tax; Taxes on Changes of Capital.* 1. Every stock corporation incorporated under any law of this state shall pay a tax * * * of five cents on each share without a par value which it is authorized to issue, and a like tax upon any shares subsequently authorized, except as hereinafter provided * * * in no case shall a tax under this section be less than ten dollars. Such tax shall be due and payable upon the incorporation and upon any subsequent authorization * * * or change of shares."

On taxation of non-par stock, see, Wickersham, Stock without Par Value, 1927, c. VI; Pierson, Stock Having No Par Value, 1922, 17 Ill.L.Rev. 173, 184; Rogers, Stamp Tax on Shares of No Par Value, 1922, 95 Cent.L.J. 448; Wickersham, The Progress of the Law on No Par Value Stock, 1924, 37 Harv.L.Rev. 464, 471; Wickersham, Taxation of No Par Value Stock, 1926, 39 Harv.L.Rev. 289; Note, 1929, 43 Harv.L.Rev. 194; 1922, 22 Col.L.Rev. 676; 1929, 29 Col.L.Rev. 1013.

bility in Minnesota, 1923, 7 Minn.L.Rev. 79, 95. See, also, Cook, The Principles of Corporation Law, 1925, 153–155; Ballantine, Nonpar Stock—Its Use and Abuse, 1923, 57 Am.L.Rev. 233; Bonbright, The Dangers of Shares Without Par Value, 1924, 24 Col.L.Rev. 449; Clay, Shares Without Par Value, 1925, 13 Ky.L.J. 274; Cook, Stock Without Par Value, 1921, 7 A.B.A.J. 534; Cook, "Watered Stock"—Commissions—"Blue Sky Laws"—Stock Without Par Value, 1921, 19 Mich.L.Rev. 583, 591–595.[60]

PAR AND NON-PAR STOCK

The invention of non-par stock and its adoption by New York in 1912 was supposed to have worked a revolutionary change in corporate procedure. But, in the light of the further developments in handling par stock, it is fairly questionable whether there is now as wide a difference between the two types of stock as was supposed.

When the par value of stock was set a generation ago, the par value was substantial. Conventionally, it was $100 per share though certain states authorized lower par values. On this par value were predicated various legal results, the most important being

(a) the doctrine that authorized but unissued par value stock could not be sold for less than par,—except under the rule of Handley v. Stutz (which, of course, left the burden of proof on the corporation to justify the necessity of the transaction);

(b) the doctrine that purchasers of par value stock of an original issue might be held liable to creditors or to the corporation in case the consideration they gave for the stock was later valued at less than the par value of the stock issued in return.

Stock without par value, it was thought, freed the transaction of issue from either danger. Since there was no fixed par, creditors could not claim an implied or other obligation to pay par value; and by its terms no-par stock could be issued for any consideration fixed by the corporation—subject only to whatever equitable restraint might be imposed by the common law rule of equitable contribution.

But the next development in par value stock supplied a practical answer. This was the amendment of incorporation laws so that the par value of shares might be virtually any amount chosen by the incorporators, instead of the old conventional figure of $100 or other substantial sum per share. Thus, in Delaware the par value may be as low as 1¢ per share; in New York, it may be as low as $1.00 per share. Yet the shares in fact were sold for prices far above this nominal par. The nominal par ceased to have any relation to the issue price of stock, which was actually determined by the corporation and its financial advisors on the basis of book value, past earnings, prospects, and so forth. Naturally, the lawyers guiding the incorporation set the par value so low that such stock rarely is issued at a price as low as par. The balance of the consideration over the par value of the shares thus issued became paid in or capital surplus.

This gave virtually complete flexibility in determining the issue price of such stock. The lowest limit on price issue was par; the upper limit was whatever the subscriber wished to pay. Since a corporation is under no obligation (other

[60] For arguments in favor of non-par stock, see Dewing, The Financial Policy of Corporations, 4th Ed., 1941, Vol. I, 70–76; Allen, Non-Par Stock, 1920, 90 Cent. L.J. 170; Colton, Par Value versus No Par Value Stock, 1921, 7 A.B.A.J. 671; Hollen and Tuttle, Uses of Stock having No Par Value, 1921, 7 A.B.A.J. 579; Morawetz, Shares Without Nominal or Par Value, 1913, 26 Harv.L.Rev. 729; Pierson, Stock Having No Par Value, 1922, 17 Ill.L.Rev. 173; Rice and Harno, Non-Par Value Stock, 1922, 56 Am.L.Rev. 321; Shaffer, Organization of Companies Under the Non-Par Value Stock Act, 1921, 55 Am.L.Rev. 438.

than as applied in the rule of equitable contribution) to demand any particular price from the original subscriber, and, conversely, the subscriber is under no obligation, implied or otherwise, to contribute more than the par value of the stock for the benefit of creditors, the double objective—flexible price and non-liability to creditors—could be achieved through the device of nominal value par, as well as through non-par stock. The statutory "capital" of a corporation thus organized is, of course, likely to be extremely low; its capital and surplus high; and the result gives substance to the comment of Sir W. S. Gilbert in his famous Bab ballad.

In result, it may fairly be asked whether, now that nominal par value of stock is with us, there is a great difference between the two types. The possibilities of use (and abuse) of nominal value par stock appear to be about the same as those of true non-par stock (see list attached).

There are still certain advantages in having substantial par value for preferred stock in some jurisdictions, but these largely relate to the power of a corporation "to write off" its capital account, the "capital" "represented by" such preferred shares on their redemption or retirement. But even such advantages can usually be secured in other ways—for instance, by transfer of part of the capital surplus to capital account, and assigning it to the particular class of shares sought to be retired.

CORPORATIONS HAVING NOMINAL PAR VALUE STOCK

Eastern Airlines Incorporated (Delaware)

December 31, 1942	Outstanding 575,608 shares of $1.00 par value stock. Carried in Balance Sheet at $2,878,040. Notation made to the effect that $1.00 par shares are carried at stated value of $5.00 a share.

Dayton Rubber Manufacturing Company (Ohio)

October 31, 1942	Outstanding 176,839 shares of $1.00 par value stock. Carried in Balance Sheet at $438,622.

Fanny Farmer Candy Shops Inc. (New York)

December 31, 1942	Outstanding 354,819 shares of $1.00 par value stock. Carried in Balance Sheet at $763,822.

International Industries Inc. (Michigan)

July 31, 1942	Outstanding 403,600 shares of $1.00 par value stock. Carried in Balance Sheet at $421,126.

Roberts Public Markets Inc. (California)

June 30, 1942	Outstanding 54,645 shares of $1.00 par value stock. Carried in Balance Sheet at $239,398.

(c) *Stockholder's Liability*

NEW YORK STOCK CORPORATION LAW.

§ 70. *Liabilities of stockholders.* Every holder of shares of stock not fully paid shall be personally liable to the creditors of the corporation, to an amount equal to the amount unpaid on the shares held by him for debts of the corporation contracted while such shares were held by him. The liability imposed by this section shall be in lieu of the liability imposed upon stockholders of any corporation existing prior to April sixteenth, nineteen hundred and one, under any general or special law, except laws relating to moneyed corporations; but nothing in this section shall create or increase any liability of stockholders of any such corporation under any special law.

§ 73. *Limitation of stockholder's liability.* No action shall be brought against a stockholder for any debt of the corporation until judgment therefor has been recovered against the corporation, and an execution thereon has been returned unsatisfied in whole or in part, and the amount due on such execution shall be the amount recoverable, with costs against the stockholder. No stockholder shall be personally liable for any debt of the corporation not payable within two years from the time it is contracted, nor unless an action for its collection shall be brought against the corporation within two years after the debt becomes due; and no action shall be brought against a stockholder after he shall have ceased to be a stockholder, for any debt of the corporation, unless brought within two years from the time he shall have ceased to be a stockholder.

DELAWARE GENERAL CORPORATION LAW.

Sec. 20. *Stockholders Liability:*—When the whole of the consideration payable for shares of a corporation shall not have been paid in, and the assets shall be insufficient to satisfy the claims of its creditors, each holder of such shares shall be bound to pay on each share held by him the sum necessary to complete the amount of the par value of such share as fixed by the charter of the company or its Certificate of Incorporation, or such proportion of that sum as shall be required to satisfy the debts of the corporation, or, in the case of stock without par value, this liability shall be limited to the unpaid balance of the consideration for which such shares were issued by the corporation. The amounts which shall be payable as hereinbefore in this Section provided may be recovered as provided for in Section 49 of this Chapter, after a writ of execution against the corporation has been returned unsatisfied, as provided for in Section 51 of this Chapter. Anything in this Chapter to the contrary notwithstanding, a holder of shares who has acquired such shares in good faith without knowledge that they were not paid in full or to the extent stated in the certificate for such shares shall not be liable either to the corporation or to its creditors for any amount beyond that shown by such certificate to be unpaid on the shares represented thereby; and any holder who derives his title through such a holder and who is not himself a party to any fraud affecting the issuance of such shares shall have all the rights of such former holder.

HOSPES et al. v. NORTHWESTERN MANUFACTURING & CAR COMPANY (MINNESOTA THRESHER MANUFACTURING COMPANY, INTERVENER.)

Supreme Court of Minnesota, 1892. 48 Minn. 174, 50 N.W. 1117.

Sequestration proceedings by E. L. Hospes & Co. against the Northwestern Manufacturing & Car Company. The Minnesota Thresher Manufacturing Company intervened, and filed a complaint against George R. Finch and others, stockholders in the Northwestern Manufacturing & Car Company. From an order overruling demurrer to the intervener's supplemental complaint George R. Finch, the St. Paul Trust Company, executor, and others, appeal. Reversed.

MITCHELL, J. This appeal is from an order overruling a demurrer to the so-called "supplemental complaint" of the Minnesota Thresher Manufacturing Company. The Northwestern Manufacturing & Car Company was a manufacturing corporation organized in May, 1882. Upon the complaint of a judgment creditor, (Hospes & Co.,) after return of execution unsatisfied, judgment was rendered in May, 1884, sequestrating all its property, things in action, and effects, and appointing a receiver of the same. This receivership still continues, the affairs of the corporation being not yet fully administered; but it appears that it is hopelessly insolvent, and that all the assets that have come into the hands of the receiver will not be sufficient to pay any considerable part of the debts. The Minnesota Thresher Manufacturing Company, a corporation organized in November, 1884, as creditor, became a party to the sequestration proceeding, and proved its claims against the insolvent corporation. In October, 1889, in behalf of itself and all other creditors who have exhibited their claims, it filed this complaint against certain stockholders (these appellants) of the car company in pursuance of an order of court allowing it to do so, and requiring those thus impleaded to appear and answer the complaint. The object is to recover from these stockholders the amount of certain stock held by them, but alleged never to have been paid for. What was said in Meagher Case, 50 N.W.R. 1114, (just decided,) is equally applicable here as to the right to enforce such a liability in the sequestration proceeding upon the petition or complaint of creditors who have become parties to it. There is nothing in this practice inconsistent with what was decided in Thresher Co. v. Langdon, 44 Minn. 37, 46 N.W.R. 310. The complaint is not the commencement of an independent action by creditors in their own behalf antagonistic to the rights of the receiver, but is filed in the sequestration proceeding itself, and in aid of it.

The principal question in the case is whether the complaint states facts showing that the thresher company, as creditor, is entitled to the relief prayed for; or, in other words, states a cause of action. Briefly stated, the allegations of the complaint are that on May 10, 1882, Seymour, Sabin & Co. owned property of the value of several million dollars, and a business then supposed to be profitable. That, in order to continue and enlarge this business, the parties interested

in Seymour, Sabin & Co., with others, organized the car company, to which was sold the greater part of the assets of Seymour, Sabin & Co. at a valuation of $2,267,000, in payment of which there were issued to Seymour, Sabin & Co. shares of the preferred stock of the car company of the par value of $2,267,000, it being then and there agreed by both parties that this stock was in full payment of the property thus purchased. It is further alleged that the stockholders of Seymour, Sabin & Co., and the other persons who had agreed to become stockholders in the car company, were then desirous of issuing to themselves, and obtaining for their own benefit, a large amount of common stock of the car company, "without paying therefor, and without incurring any liability thereon or to pay therefor;" and for that purpose, and "in order to evade and set at naught the laws of this state," they caused Seymour, Sabin & Co. to subscribe for and agree to take common stock of the car company of the par value of $1,500,000. That Seymour, Sabin & Co. thereupon subscribed for that amount of the common stock, but never paid therefor any consideration whatever, either in money or property. That thereafter these persons caused this stock to be issued to D. M. Sabin as trustee, to be by him distributed among them. That it was so distributed without receipt by him or the car company from any one of any consideration whatever, but was given by the car company and received by these parties entirely "gratuitously." The car company was, at this time, free from debt, but afterwards became indebted to various persons for about $3,000,000. The thresher company, incorporated after the insolvency and receivership of the car company, for the purpose of securing possession of its assets, property, and business, and therewith engaging in and continuing the same kind of manufacturing, prior to October 27, 1887, purchased and became the owner of unsecured claims against the car company, "*bona fide*, and for a valuable consideration," to the aggregate amount of $1,703,000. As creditor, standing on the purchase of these debts, which were contracted after the issue of this "bonus" stock, the thresher company files this complaint to recover the par value of the stock as never having been paid for. The complaint does not allege what the consideration of these debts was, nor to whom originally owing, nor what the intervener paid for them, nor whether any of the original creditors trusted the car company on the faith of the bonus stock having been paid for. Neither does it allege that either the thresher company or its assignors were ignorant of the bonus issue of stock, nor that they or any of them were deceived or damaged in fact by such issue, nor that the bonus stock was of any value. Neither is there any traversable allegation of any actual fraud or intent to deceive or injure creditors. A desire to get something without paying for it, and actually getting it, is not fraudulent or unlawful if the donor consents, and no one else is injured by it; and the general allegation that it was done "in order to evade and set at naught the laws of the state" of itself amounts to nothing but a mere conclusion of law. As a creditors' bill, in the ordinary sense, the complaint is manifestly insufficient. The thresher company, however, plants itself upon the so-called "trust-fund" doctrine that the capital stock

of a corporation is a trust fund for the payment of its debts; its contention being that such a "bonus" issue of stock creates, in case of the subsequent insolvency of the corporation, a liability on part of the stockholder in favor of creditors to pay for it, notwithstanding his contract with the corporation to the contrary.

This "trust fund" doctrine, commonly called the "American doctrine," has given rise to much confusion of ideas as to its real meaning, and much conflict of decision in its application. To such an extent has this been the case that many have questioned the accuracy of the phrase, as well as doubted the necessity or expediency of inventing any such doctrine. While a convenient phrase to express a certain general idea, it is not sufficiently precise or accurate to constitute a safe foundation upon which to build a system of legal rules. The doctrine was invented by Justice Story in Wood v. Dummer, 3 Mason, 308, which called for no such invention, the fact in that case being that a bank divided up two-thirds of its capital among its stockholders without providing funds sufficient to pay its outstanding bill-holders. Upon old and familiar principles this was a fraud on creditors. Evidently all that the eminent jurist meant by the doctrine was that corporate property must be first appropriated to the payment of the debts of the company before there can be any distribution of it among stockholders,—a proposition that is sound upon the plainest principles of common honesty. In Fogg v. Blair, 133 U.S. 541, 10 S.Ct. 338, it is said that this is all the doctrine means. The expression used in Wood v. Dummer has, however, been taken up as a new discovery, which furnished a solution of every question on the subject. The phrase that "the capital of a corporation constitutes a trust fund for the benefit of creditors" is misleading. Corporate property is not held in trust, in any proper sense of the term. A trust implies two estates or interests,—one equitable and one legal; one person, as trustee, holding the legal title, while another, as the *cestui que trust,* has the beneficial interest. Absolute control and power of disposition are inconsistent with the idea of a trust. The capital of a corporation is its property. It has the whole beneficial interest in it, as well as the legal title. It may use the income and profits of it, and sell and dispose of it, the same as a natural person. It is a trustee for its creditors in the same sense and to the same extent as a natural person, but no further. This is well illustrated and clearly announced in the case of Graham v. Railway Co., 102 U.S. 148. That was a creditors' suit to reach a piece of real estate on the ground that it had been conveyed by the corporation fraudulently for a wholly inadequate consideration. The trust-fund doctrine was invoked by a subsequent creditor, and it was claimed that, as the trust had been violated, the deed should be set aside. If the premise was correct that the corporation held it in trust for creditors, the conclusion was inevitable; but the court denied the premise, saying that a corporation is in law as distinct a being as an individual is, and is entitled to hold property (if not contrary to its charter) as absolutely as an individual can hold it. Its estate is the same, its interest is the same, its possession is the same; and that there is no reason why the disposal by a corporation of any of its property should be questioned by

subsequent creditors any more than a like disposal by an individual; that the same principles of law apply to each. That the phrase that "the capital of a corporation is a trust fund for the payment of its creditors" is misleading, if not inaccurate, is illustrated by the character of the actions that are frequently mistakenly instituted on the strength of it. For example, in the case of Railroad Co. v. Ham, 114 U.S. 587, 5 S.Ct. 1081, two roads had been consolidated, the new company acquiring the property of the old ones. A creditor of one of the old companies, on the strength of the "trust-fund" doctrine, claimed a lien on its property in the hands of the new corporation. If this property was impressed with a trust in favor of creditors in the hands of the old company, it would logically follow that it would continue so in the hands of the new one. But the court denied the relief, and, in giving its construction of the "trust-fund" doctrine, said: "The property of a corporation is doubtless a trust fund for the payment of its debts in the sense that when the corporation is lawfully dissolved, and all its business wound up, or when it is insolvent, all its creditors are entitled in equity to have their debts paid out of the corporate property before any distribution thereof among stockholders. It is also true, in the case of a corporation as in the case of a natural person, that any conveyance of the property of the debtor without authority of law and in fraud of existing creditors is void." This is probably what is meant when it is said in some cases, as in Clark v. Bever, 139 U.S. 110, 11 S.Ct. 468, that the capital of a corporation is a trust fund *sub modo*. If so, no one will dispute it. But it means very little, for the same thing could be truthfully said of the property of an individual or a partnership. And obviously it would make no difference whether the disposition of the corporate property is to a stranger or to a stockholder, except that, of course, the latter could not be an innocent purchaser.

There is also much confusion in regard to what the "trust-fund" doctrine applies. Some cases seem to hold that unpaid subscribed capital is a trust fund, while other assets are not,—that is, so long as the subscription is unpaid, it is held in trust by the corporation, but, when once paid in, it ceases to be a trust fund; while other cases hold that, paid or unpaid, it is all a trust fund. The first seems to be the rule laid down in Sawyer v. Hoag, 17 Wall. 610, in which the "trust-fund" doctrine was first squarely announced by that court with all the vigor and force characteristic of the great jurist who wrote the opinion. In that case a stockholder in an insurance company had given his note, as the court found the fact to be, for 85 per cent. of his subscription to the stock of the company. After the company had become bankrupt, and the stockholder knew the fact, he brought up a claim against the company for one-third its face, and in a suit by the assignee in bankruptcy on his note set up this claim as an offset. That this would have been a fraud on the bankrupt act, and at least a moral fraud on policy-holders, is quite apparent without invoking the "trust-fund" doctrine; and, if the note for unpaid stock was a trust fund, there could have been no offset, whether the company was solvent or insolvent. In the opinion it is said that, "if the subscription had been

paid by the note or otherwise, the note ceased thereby to be a trust fund to which creditors can look, and became ordinary assets, with which directors may deal as they choose." But in Upton v. Tribilcock, 91 U.S. 45, it is stated: "The capital paid in and promised to be paid in is a fund which the trustees cannot squander or give away." While in Sanger v. Upton, Id. 56, it is said: "When debts are incurred a contract arises with the creditors that it [the capital] shall not be withdrawn or applied otherwise than upon their demands until such demands are satisfied." And in the same connection it is distinctly stated that there is no difference between assets paid in and subscriptions; that "unpaid stock is as much a part of this pledge and as much a part of the assets of the company as the cash which has been paid in upon it; that creditors have the same right to look to it as to anything else, and the same right to insist upon its payment as upon the payment of any other debt due the company; that, as regards creditors, there is no distinction between such a demand and any other asset which may form a part of the property and effects of the corporation." This language is quoted and approved in County of Morgan v. Allen, 103 U.S. 508. It would seem clear that this is the correct statement of the law. The capital (not the mere share certificates) means all the assets, however invested. If a subscriber gives his note for his stock, that note is no more and no less a trust fund than the money would have been if he had paid cash down. Capital cannot change from a trust to not a trust by a mere change of form. It is either all a trust or all not a trust, and the "trust-fund" rule, whatever that be, must apply to all alike, and in the same way. If the assets of a corporation are given back to stockholders, the result is the same as if the shares had been issued wholly or partly as a bonus. The latter is merely a short cut to the same result. So with dividends paid out of the capital, voluntary conveyances, stock paid in overvalued property; all are forms of one and the same thing, all reaching the same result, (a disposition of corporate assets,) which may or may not be a fraud on creditors, depending on circumstances. This much being once settled, the solution of the question when a subsequent creditor can insist on payment of stock issued as paid up, but not in fact paid for, or not paid for at par, becomes as we shall presently see, comparatively simple.

Another proposition which we think must be sound is that creditors cannot recover on the ground of contract when the corporation could not. Their right to recover in such cases must rest on the ground that the acts of the stockholders with reference to the corporate capital constitute a fraud on their rights. We have here a case where the contract between the corporation and the takers of the shares was specific that the shares should not be paid for. Therefore, unlike many of the cases cited, there is no ground for implying a promise to pay for them. The parties have explicitly agreed that there shall be no such implication by agreeing that the stock shall not be paid for. In such a case the creditors undoubtedly may have rights superior to the corporation, but these rights cannot rest on the implication that the shareholder agreed to do something directly contrary to his real agreement, but must be based on tort or fraud, actual or presumed.

In England, since the act of 1867, there is an implied contract created by statute that "every share in any company shall be deemed and be taken to have been issued and to be held subject to the payment of the whole amount thereof in cash." This statutory contract makes every contrary contract void. Such a statute would be entirely just to all, for every one would be advised of its provisions, and could conduct himself accordingly. And in view of the fact that "watered" and "bonus" stock is one of the greatest abuses connected with the management of modern corporations, such a law might, on grounds of public policy, be very desirable. But this is a matter for the legislature, and not for the courts. We have no such statute; and, even if the law of 1873, under which the car company was organized, impliedly forbids the issue of stock not paid for, the result might be that such issue would be void as *ultra vires,* and might be canceled, but such a prohibition would not of itself be sufficient to create an implied contract, contrary to the actual one, that the holder should pay for his stock.

It is well settled that an equity in favor of a creditor does not arise absolutely and in every case to have the holder of "bonus" stock pay for it contrary to his actual contract with the corporation. Thus no such equity exists in favor of one whose debt was contracted prior to the issue, since he could not have trusted the company upon the faith of such stock. First Nat. Bank v. Gustin M. C. Min. Co. 42 Minn. 327, 44 N.W. 198; Coit v. Amalgamating Co., 119 U.S. 347, 7 S.Ct. 231; Handley v. Stutz, 139 U.S. 435, 11 S.Ct. 530. It does not exist in favor of a subsequent creditor who has dealt with the corporation with full knowledge of the arrangement by which the "bonus" stock was issued, for a man cannot be defrauded by that which he knows when he acts. First Nat. Bank v. Gustin M. C. Min. Co., supra. It has also been held not to exist where stock has been issued and turned out at its full market value to pay corporate debts. Clark v. Bever, supra. The same has been held to be the case where an active corporation, whose original capital has been impaired, for the purpose of recuperating itself issues new stock, and sells it on the market for the best price obtainable, but for less than par, (Handley v. Stutz, supra;) although it is difficult to perceive, in the absence of a statute authorizing such a thing, (of which every one dealing with the corporations is bound to take notice,) any difference between the original stock of a new corporation and additional stock issued by a "going concern." It is difficult, if not impossible, to explain or reconcile these cases upon the "trust-fund" doctrine, or, in the light of them, to predicate the liability of the stockholder upon that doctrine. But by putting it upon the ground of fraud, and applying the old and familiar rules of law on that subject to the peculiar nature of a corporation and the relation which its stockholders bear to it and to the public, we have at once rational and logical ground on which to stand. The capital of a corporation is the basis of its credit. It is a substitute for the individual liability of those who own its stock. People deal with it and give it credit on the faith of it. They have a right to assume that it has paid in capital to the amount which it represents itself as having; and if they give it credit on the faith of that representation, and if the representation is false, it is a

fraud upon them; and, in case the corporation becomes insolvent, the law, upon the plainest principles of common justice, says to the delinquent stockholder, "Make that representation good by paying for your stock." It certainly cannot require the invention of any new doctrine in order to enforce so familiar a rule of equity. It is the misrepresentation of fact in stating the amount of capital to be greater than it really is that is the true basis of the liability of the stockholder in such cases; and it follows that it is only those creditors who have relied, or who can fairly be presumed to have relied, upon the professed amount of capital, in whose favor the law will recognize and enforce an equity against the holders of "bonus" stock. This furnishes a rational and uniform rule, to which familiar principles are easily applied, and which frees the subject from many of the difficulties and apparent inconsistencies into which the "trust-fund" doctrine has involved it; and we think that, even when the trust-fund doctrine has been invoked, the decision in almost every well-considered case is readily referable to such a rule.

It is urged, however, that, if fraud be the basis of the stockholders' liability in such cases, the creditor should affirmatively allege that he believed that the bonus stock had been paid for, and represented so much actual capital, and that he gave credit to the incorporation on the faith of it; and it is also argued that, while there may be a presumption to that effect in the case of a subsequent creditor, this is a mere presumption of fact, and that in pleadings no presumptions of fact are indulged in. This position is very plausible, and at first sight would seem to have much force; but we think it is unsound. Certainly any such rule of pleading or proof would work very inequitably in practice. Inasmuch as the capital of a corporation is the basis of its credit, its financial standing and reputation in the community has its source in, and is founded upon, the amount of its professed and supposed capital, and every one who deals with it does so upon the faith of that standing and reputation, although, as a matter of fact, he may have no personal knowledge of the amount of its professed capital, and in a majority of cases knows nothing about the shares of stock held by any particular stockholder, or, if so, what was paid for them. Hence, in a suit by such creditor against the holders of "bonus" stock, he could not truthfully allege, and could not affirmatively prove, that he believed that the defendants' stock had been paid for, and that he gave the corporation credit on the faith of it, although, as a matter of fact, he actually gave the credit on the faith of the financial standing of the corporation, which was based upon its apparent and professed amount of capital. The misrepresentation as to the amount of capital would operate as a fraud on such a creditor as fully and effectually as if he had personal knowledge of the existence of the defendants' stock, and believed it to have been paid for when he gave the credit. For this reason, among others, we think that all that it is necessary to allege or prove in that regard is that the plaintiff is a subsequent creditor; and that, if the fact was that he dealt with the corporation with knowledge of the arrangement by which the "bonus" stock was issued, this is a matter of defense. Gogebic Inv. Co. v. Iron Chief Min. Co., 78 Wis. 427, 47

N.W. 726. Counsel cites Fogg v. Blair, supra, to the proposition that the complaint should have stated that this stock had some value; but that case is not in point, for the plaintiff there was a prior creditor; and, as his debt could not have been contracted on the faith of stock not then issued, he could only maintain his action, if at all, by alleging that the corporation parted with something of value.

In one respect, however, we think the complaint is clearly insufficient. The thresher company is here asking the interposition of the court to aid in enforcing an equity in favor of creditors against the stockholders by declaring them liable to pay for this stock contrary to their actual contract with the corporation. While the proceeding is not, strictly speaking, an equitable action, yet the relief asked is equitable in its nature. Under such circumstances, it was incumbent upon the thresher company to show its own equities, and that it was in a position to demand such relief. It was not the original creditor of the car company, but the assignee of the original creditors. By that purchase it, of course, succeeded to whatever strictly legal rights its assignors had; but it is not rights of that kind which it is here seeking to enforce. Under such circumstances, we think it was incumbent upon it to state what it paid for the claims, or at least to show that it paid a substantial, and not a mere nominal consideration. The only allegation is that it paid "a valuable consideration." This might have been only one dollar. It appears that it bought the claims after the car company had become insolvent, and its affairs were in the hands of a receiver; also that the indebtedness of that company amounted to about $3,000,000, and that there were not corporate assets enough to pay any considerable part of it. The mere chance of collecting something out of the stockholders does not ordinarily much enhance the selling price of claims against an insolvent corporation. If any person or company had gone to work and bought up for a mere song this large indebtedness of the car company for the purpose of speculating on the liability of the stockholders, no court would grant them the relief here prayed for. It would say to them, "We will not create and enforce an equity for the benefit of any such speculation." Counsel for respondent suggests that the thresher company is but an organization of the original creditors, who formed it, and pooled their claims, so as to save something out of the wreck of the car company; but nothing of the kind is alleged. On this ground the demurrer should have been sustained.

In view of further proceedings it may be proper to say that in our opinion there is nothing in the position that the right of recovery against the stockholders was barred by the statute of limitation. The argument in support of the proposition all rests upon the false premise that the cause of action accrued in May, 1882, when the bonus stock was issued. The corporation never had any cause of action against these defendants. As between them and the company, the agreement for the issue of the stock was valid. The creditors are not here seeking to enforce a right of action acquired through or from the corporation, but one that accrued directly to themselves, or for their benefit, and that did not accrue at least until the corporation became insolvent, in May, 1884.

Counsel for the St. Paul Trust Company stated that, if the court should reverse the order appealed from on any of the grounds urged by the other appellants, it would not be necessary for us to consider any of the assignments of error peculiar to his appeal; but, as we reverse upon a ground that may be remedied by amendment, we deem it proper to say that, in our opinion, the claim against the Kittson estate is a "contingent" claim, within the meaning of Gen.St. 1878, c. 53.

Order reversed.

G. LOEWUS & COMPANY, INCORPORATED v. HIGHLAND QUEEN PACKING COMPANY.

Court of Chancery of New Jersey, 1939. 125 N.J.Eq. 534, 6 A.2d 545.

Suit by G. Loewus & Company, Inc., against the Highland Queen Packing Company, an insolvent corporation, wherein a receiver was appointed for the Highland Queen Packing Company. The receiver seeks to have three stockholders in the Highland Queen Packing Company assessed a sum sufficient to pay creditors and administration expenses, on the theory that their stock is not fully paid for.

Decree for the stockholders.

BIGELOW, VICE CHANCELLOR. The receiver of the defendant Highland Queen Packing Company, an insolvent New Jersey corporation, prays that its three stockholders be assessed a sum sufficient to pay creditors and administration expenses, on the theory that their stock is not fully paid.

The stock is without par value, issued pursuant to R.S. 14:8–6, N.J.S.A. 14:8–6, "Every corporation organized under this title may issue and may sell its authorized shares without nominal or par value, from time to time, for such consideration as may be prescribed in the certificate of incorporation, or, if so provided in the certificate of incorporation, as from time to time may be fixed by the board of directors. * * *

"Any and all shares without nominal or par value issued as permitted by this article shall be deemed fully paid and nonassessable, and the holder of such shares shall not be liable to the corporation or its creditors in respect thereof."

Defendant's certificate of incorporation, pursuant to the statute, authorizes the board of directors to fix the price of the stock. The directors, at their organization meeting, received and accepted an offer from two of the respondents, Jesse B. Triplett and Boice E. Triplett, to sell to the corporation the business then being conducted by them in consideration of the assumption of debts, and especially a note to the third respondent, Edgar H. Lackey, for $950 and for the further consideration of 300 shares of capital stock to be divided among the three respondents: "It is understood that the said shares of stock shall be issued at the price of $20 per share and representing a total value of $6,000."

The sale was consummated, and the stock issued. As part of the transaction, Lackey paid the company $1,050 which he had promised

the Tripletts to put in the business. The corporation books show a debt to Lackey of $2,000, namely, the amount of the promissory note, plus his additional payment, but Lackey denies that the company is so indebted to him. "I was not in charge of the books of the defendant corporation nor did I have an opportunity to examine them before the receiver was appointed in this case. In truth, I gave the said sum of $2,000 in payment for the said stock."

The assets and good will of the business turned over by the Tripletts to the corporation were worth only $1,500, so it is alleged. The receiver takes the position that the consideration for the stock fixed by the directors was $20 per share, or a total of $6,000, of which only $1,500, or $1,500 plus $1,050, has been paid, and that there is owing by the stockholders the difference or so much thereof as may be necessary to satisfy creditors.

The duty of holders of par value stock—as distinguished from non-par stock—to contribute toward the payment of creditors finds three supports: One is the contract of the subscriber to pay a certain amount for his shares. Milliken v. Caruso, 205 N.Y. 559, 98 N.E. 493. Upon the insolvency of the company and the abandonment of its business, he is relieved of his obligation except so far as may be necessary to satisfy creditors. But his contractual debt to that extent remains enforceable at the suit of creditors or receiver. Wetherbee v. Baker, 35 N.J.Eq. 501; Cumberland Lumber Co. v. Clinton Hill Lumber Mfg. Co., 57 N.J.Eq. 627, 42 A. 585; Hood v. McNaughton, 54 N.J.L. 425, 24 A. 497. Second comes the trust fund or fraud theory which rests liability upon the representation or holding out to persons extending credit to the company, that its capital, in a certain sum, has been paid in full. The third basis for liability is statutory. "It depends upon the stockholder's voluntary acceptance, for considerations touching his own interest, of a statutory scheme to which watered stock, under whatever device issued, is absolutely alien, and which requires stock subscriptions to be made good for the benefit of creditors of insolvent companies." Easton National Bank v. American Brick Co., 70 N.J.Eq. 732, 738, 64 A. 917, 920, 8 L.R.A.,N.S., 271, 10 Ann.Cas. 84.

The statutory plan on which stockholders' liability depends is found principally in three sections of our corporation act, R.S. 14:8–13, N.J. S.A. 14:8–13 (formerly Rev., p. 178, sec. 5; C.S. p. 1610, sec. 21), provides that where the capital shall not have been paid in full, and the capital paid shall be insufficient to satisfy debts, each stockholder shall be bound to pay the sum necessary to complete the amount of each share held by him or such proportion thereof as shall be required to satisfy the creditors. The other two sections are R.S. 14:8–9, N.J.S.A. 14:8–9 (formerly Rev. p. 186, sec. 54; C.S. p. 1630, sec. 48) and R.S. 14:3–9, N.J.S.A. 14:3–9 (formerly Rev. p. 187, sec. 55; C.S. p. 1630, sec. 49). In the event less than the full amount of the stock is paid and the company becomes insolvent, the stockholders are liable to pay in the balance regardless of any contract or understanding which they had with the corporation, for any agreement by the company to accept less than par is void as to creditors. Liability does not depend on a "holding out" to creditors.

Par value stock has a definite value, fixed by the certificate of incorporation, stated in terms of dollars, but it may be issued for money or property or services. Stock without par value is issued for a "consideration" prescribed by the certificate of incorporation or by directors or stockholders. The consideration fixed may be money or property, or anything that constitutes a good and valuable consideration. Allenhurst Park Estates v. Smith, 101 N.J.Eq. 581, 610, 138 A. 709.

In Smith v. General Motors Corp., 6 Cir., 289 F. 205, a suit by a solvent corporation on a subscription to its stock, the circuit court of appeals said that a subscription for stock of a definite par value and one for no par value stock at a fixed and definite price, seemed to depend upon the same principles and affirmed a judgment for the amount due on the subscription to non-par stock.

Likewise, in the case of insolvency, pretty much the same principles determine the obligations of subscribers and holders of either class of stock. If the consideration for non-par stock is duly fixed at $20 a share, and only $10 a share is paid in, then R.S. 14:8–13, N.J.S.A. 14:8–13, becomes effective and the stockholders may be assessed. Or if the consideration be certain property and the stock is issued though only a part of the property is transferred to the corporation, the stockholders must answer to the call of creditors.

Counsel for respondents direct attention to the provision in R.S. 14:8–6, N.J.S.A. 14:8–6, that "shares without nominal or par value issued as permitted by this article shall be deemed fully paid and non-assessable, and the holder of such shares shall not be liable to the corporation or its creditors in respect thereof." A similar provision relating to par value stock issued for property is found in R.S. 14:3–9, N.J.S.A. 14:3–9, and has been part of our statute law many years. "The stock so issued shall be fully paid stock and not liable to any further call." Prior to 1917, the statute also declared, "neither shall the holder thereof be liable for any further payment under any of the provisions of this act." Despite these provisions, a holder, with notice, of par value stock issued for property at an inflated valuation is liable to creditors. Easton National Bank v. American, etc., Co., 70 N.J.Eq. 732, 64 A. 1095; See v. Heppenheimer, 69 N.J.Eq. 36, 61 A. 843; Holcombe v. Trenton White City Co., 80 N.J.Eq. 122, 82 A. 618; Id., 82 N.J.Eq. 364, 91 A. 1069; Bryson v. Conlen, 104 N.J.Eq. 180, 144 A. 723. So when stock without par value is issued for less than the prescribed consideration, it is outside the plan of the statute, and the holder thereof, with notice, is liable for the balance of the consideration, or so much thereof as may satisfy creditors.

Another clause of R.S. 14:8–6, N.J.S.A. 14:8–6, gives the board of directors, within 30 days after issuance of such stock, power to allocate part of the consideration to surplus. Dividends may be made out of the surplus thus created, but not out of the capital. R.S. 14:8–19, N.J.S.A. 14:8–19. Since the directors of the defendant corporation did not exercise this power, I need not consider the possible effect on creditors' rights, of an assignment to surplus of part of the consideration for which the stock was issued.

The question remains whether there was delivered to the corporation in exchange for the stock the full consideration as fixed by the directors. Careful examination of the minutes satisfies me that the only consideration which the Tripletts offered to give and the directors agreed to accept, was the transfer of the business conducted by the Tripletts. The directors, by accepting the offer, fixed the consideration for the stock within the intent of R.S. 14:8–13, N.J.S.A. 14:8–13. The meaning of the statement in the minutes that the stock should be issued at the price of $20 per share, or a total value of $6,000, is not clear. Certainly the parties did not intend that $6,000 should be paid in, additional to the transfer of the business, or even that the difference between $6,000 and the value of the business should be paid in. Probably the sentence has some relation to the deal with Lackey, who was paying $2,000 for a third interest in the enterprise.

The duly fixed consideration for the stock was fully satisfied and the stockholders are not assessable.

The receiver also asks that the Tripletts be ordered to deliver to the receiver certain formulas which, he claims, they sold to the corporation. The proofs disclose, however, that they sold only the right to use the formulas so long as the corporation should exist as a going concern. Order denied.

LIVINGSTON v. ADAMS et al.

St. Louis Court of Appeals of Missouri, 1931. 226 Mo.App. 824, 43 S.W.2d 836.

Action by Orville Livingston, as trustee, against Roscoe G. Adams and others. From judgment for plaintiff, defendant Herman Dreste appeals.

Affirmed

BECKER, J. Plaintiff brought this action against three defendants in which he seeks to recover for unpaid subscriptions of capital stock of a Missouri corporation, the stock of which is without nominal or par value. A trial before the court resulted in plaintiff obtaining a judgment against the defendants. The judgment against defendant Herman Dreste was for $1,172.50, from which judgment said defendant prosecutes this appeal. * * *

That on November 14, 1928, plaintiff, as trustee, as aforesaid, filed with the Honorable Walter D. Coles, referee, a petition * * * alleging the liability of defendants on account of their subscriptions to the capital stock of said bankrupt, and requested to be authorized to institute suit against all of the delinquent subscribers to the capital stock of said corporation to enforce liability of said subscribers, including defendants herein, and that in said petition filed before the referee, the plaintiff, as trustee, further alleged that there remained due and owing on the capital stock of said company the sum of at least $4,660, and that defendants herein and each of them are liable as subscribers to the capital stock of said bankrupt. Thereupon plaintiff was authorized, empowered, and directed by said referee in bankruptcy to bring suit against any and all persons who then were, or at any time may

have been, holders of the capital stock of said corporation or subscribers to the capital stock thereof, especially these defendants, to enforce any liability against them arising out of the subscriptions for said stock.

Plaintiff's petition in the instant case further alleges that this appellant is one of the original incorporators of said corporation which was incorporated on April 10, 1927, and that said shares of stock were of nominal or no par value, and that it began business with $5,000, which consisted of $2,000 cash, $3,000 in property, but alleges that no money was put up as part of the capital and that the property transferred by the incorporators to said corporation in payment of said capital stock amounted to not more than $335; that as incorporators the defendant Dreste subscribed for 134 shares, Roscoe G. Adams and George L. Ford, 133 shares each, and that the defendants, by reason of said subscriptions, became liable to the creditors in the amount of $4,665, and each defendant became liable as follows: Dreste, $1,575; Adams, $1,562.50; and Ford, $1,527.50. That the unpaid part of the capital stock is a liability against defendants.

Defendant Dreste filed a general and special demurrer to said petition, which was overruled.

Defendant Dreste's answer is a general denial and set-off for $821.38. * * *

The original articles of association of the Dreste-Adams-Ford Music Corporation, which were introduced in evidence, contain the statement that the total number of shares authorized is 500, which shares are without nominal or par value; and further shows that 400 of the shares had been subscribed for, of which amount the defendant Herman Dreste had subscribed for 134 shares; and contains the further statement:

"(b) The amount of capital with which the corporation will begin business is five thousand dollars ($5,000.00), two thousand dollars ($2,000.00) of which is paid up in lawful money of the United States and is in the custody of the persons named as the first board of directors or managers, and three thousand dollars ($3,000.00) of which is actually paid up in property now in the custody of the persons named as the first board of directors or managers, an itemized description of which with the cash value of each item and location thereof, is as follows:

"10 Radios of cash value of $1500.00

"12 Phonographs of cash value of $1500.00

"Said property being now located at the R. U. Leonori Auction & Storage Company, Grand and Laclede Avenues, in the City of St. Louis, Missouri."

Appended to these articles of incorporation is the usual acknowledgment of the several subscribers to the stock and the further affidavit on the part of each of such subscribers, including the defendant Herman Dreste, that the statements and matters set forth are true and that they know the property described in article 3 of said articles of agreement and taken in payment of capital stock, and that the value placed on the same is the actual cash value of such property.

It is conceded that the liability of the stockholders of the Dreste-Adams-Ford Music Corporation for alleged unpaid subscriptions depends upon the laws of this state. The following sections of our statutes bear upon the question. They appear under article 16, chapter 32, Revised Statutes of Missouri 1929, as follows:

"Sec. 5100. Stock corporations, other than building and loan associations, trust companies, etc.—shares, par value—capital.—Upon the formation * * * of any stock corporation * * * provision may be made for the issue of shares of preferred stock of any or all classes, or common stock of any class, or both preferred and common stock, without any nominal or par value, by stating in the articles of association or certificate of incorporation: * * *

"(a) The number of shares with nominal or par value, and the number of shares without nominal or par value, that may be issued by the corporation, and the classes, if any, into which such shares are divided;

"(b) the nominal or par value of shares of stock other than shares which it is stated are to have no nominal or par value;

"(c) the amount of capital with which the corporation will begin business.

"Sec. 5101. Amount of capital stock shall be fully paid in.—No corporation authorized to issue shares of stock without nominal or par value in pursuance of the provisions of this article shall begin to carry on business, or shall incur any indebtedness, until the amount of the capital with which it will begin business stated in pursuance of section 5100 of this article, shall have been fully paid in cash or in property."

"Sec. 5104. Authorized shares may be issued, when.—Such corporation may issue and may dispose of its authorized shares having no nominal or par value, from time to time, for such consideration as may be prescribed or authorized in the articles of association or certificate of incorporation. * * *

"Sec. 5105. Shares shall be deemed fully paid and nonassessable.—Any and all shares without nominal or par value, issued for the consideration as prescribed or fixed in accordance with the provisions of section 5104 of this article, shall be deemed fully paid and be nonassessable, and the holder of such shares shall not be liable thereon to the corporation or to its creditors."

Prior to the act of 1921 there was no authority for corporations to issue shares of stock without nominal or par value. And as to corporations organized with nominal or par value stock, it has uniformly been held that the amount of money or property represented as the original capital is a trust fund for the benefit of its creditors, and that creditors have a right to rely upon the assumption that the original stock so subscribed for has been full paid [citing cases.] * * * and that the property accepted in payment of capital stock of the corporation has been taken at fair valuation, and that the issuance of capital stock for property not equal to its par value is a fraud in law upon its creditors. [Citing cases] * * *

It is well-settled law in this state that in so far as creditors are concerned, unpaid stock subscriptions, in corporations organized with nominal or par value stock, are in equity considered assets of the corporation and that they may be subjected to the payment of the debts of the corporation where the creditor gave it credit relying upon the belief that the stock had been fully paid. * * *

The above principles were definitely established when the act of 1921 was passed, under which corporations could be formed with common stock without any nominal or par value. To what extent are these settled principles modified, if at all, by the act of 1921, which permits the incorporation of companies without any nominal or par value stock?

Section 5100, Rev.Stat. Mo.1929, provides for the formation of such corporations "by stating in the articles of association or certificate of incorporation * * * in lieu of statements which may be prescribed by law as to the amount of capital stock and the number and par value of shares into which it is divided:

"(a) * * * the number of shares without nominal or par value, that may be issued by the corporation. * * *

"(b) * * *

"(c) the amount of capital with which the corporation will begin business. * * *"

Section 5101 provides that no corporation authorized to issue shares of stock without nominal or par value shall begin to carry on business or shall incur any indebtedness *until the amount of the capital* with which it will begin business, stated in pursuance of section 5100, *shall be fully paid in cash or property.*

Section 5105 provides that any and all shares without nominal or par value *issued for the consideration fixed in accordance with the provisions of section 5104,* shall be deemed fully paid and be nonassessable, and *the holders of such shares* shall not be liable thereon to the corporation or to its creditors.

Section 5110 provides that shares of stock without nominal or par value shall be deemed to be an aliquot part of the aggregate capital of the corporation issuing the same, and equal to every other share of stock of the same class.

The statutes of New York, Illinois, Idaho, New Jersey, and other states permitting the issuance of no par value stock, provide, as does our own act, for a statement in the certificate of incorporation of the amount of capital that the corporation begins business with, and this stated capital is the so-called "trust fund" for the benefit of its creditors. See State ex rel. Standard Tank Co. v. Sullivan, Secretary of State, 282 Mo. 261, 221 S.W. 728, loc. cit. 737.

Under the sections of our statutes cited supra, the Legislature did not intend to abolish the trust fund theory as respects nonpar value stock corporations. This is evidenced from the very language of the sections themselves, for it is provided by them that no such corporation shall begin business until the amount of the capital it will begin business with, as *stated* in its articles of association, shall have been fully paid in cash or property, and such *stated* capital shall be the

capital with which the corporation shall begin business (section 5102), and all shares *issued for such consideration* shall be deemed fully paid and be nonassessable, and that the holders of *such shares* shall not be liable thereon to the corporation or to its creditors, clearly showing that the general rules regarding liability for unpaid stock subscriptions for par value corporation stock would otherwise apply, namely, a liability therefor of the corporation to its creditors. In our opinion these sections intend that the payment of the consideration that may be prescribed or authorized in the articles of association or certificate of incorporation for which the nonpar value stock is issued by the corporation, must in fact be paid, and that the amount which each subscriber for shares may be liable for is to be determined according to the provisions of section 5110, which provides that shares of stock of no par value shall be deemed to be an aliquot part of the aggregate capital of the corporation issuing the same and equal to every other share of stock of the same class.

Our Supreme Court has specifically held that there can be no question but that the state, in granting corporations the privilege of issuing shares without par value, may impose such conditions as it chooses; if the conditions are regarded as too onerous, the privilege must be foregone. * * *

Reading the act of 1921 as a whole, "it is manifest that it was the purpose of the Legislature in permitting corporations to issue shares of stock without any nominal or par value to impose upon them, so far as was consistent with the general purpose of the act, the same burdens, restrictions, and regulations which were then imposed by existing law upon other stock corporations, and which, as stated, were based in some respect on the amount of capital stock." State v. Pierce Petroleum Corp., 318 Mo. 1020, loc. cit. 1025, 2 S.W.2d 790, 793; State ex rel. v. Becker, supra.

In the instant case, having elected in the articles of association to state that the amount of capital with which the corporation will begin business is $5,000, $2,000 of which was stated as being cash and the balance paid up in property of the cash value of $3,000, when in point of fact only a fractional part of such capital, either in cash or property, was ever paid up by the original subscribers, upon the bankruptcy of the corporation, and under the facts alleged in the petition herein, we rule that a subscriber to the original stock, such as appellant, must be held to have agreed to contribute a definite amount to the capital stock, and having failed to do so must respond in a proper action for the difference between what he actually agreed to pay for his stock and the actual consideration which he may have paid the company therefor. It follows that the demurrer ore tenus was well ruled.

It is further urged that since the record discloses that the defendant Dreste had advanced or loaned the company the sum of $466.42, he should have been permitted to set off same against any alleged balance for any unpaid stock that might be found due from him to the corporation.

Debts to be subject to set-off must be mutual; must be in the same right. The case before us, however, is not of that character. The debt which appellant owed for his stock was a trust fund devoted to the payment of all the creditors of the company. As soon as the company became insolvent, the right of set-off for an ordinary debt to its full amount ceased. It became a fund belonging equally in equity to all the creditors and could not be appropriated by the debtor to the exclusive payment of his own claim. Sawyer v. Hoag, 84 U.S. (17 Wall.) 610, loc. cit. 623, 21 L.Ed. 731.

The judgment is for the right party, and finding no error prejudicial to the rights of the appellant, the judgment should be affirmed. It is so ordered.

3. PREEMPTIVE RIGHTS

NEW YORK STOCK CORPORATION LAW

§ 39. *Preemptive rights.* 1. As used in this section, (a) the term "unlimited dividend rights" shall mean the right without limitation as to amount either to all or to a share of the balance of current or liquidating dividends after the payment of dividends on any shares entitled to preference;

(b) the term "equity shares" shall mean shares of any class, whether or not preferred as to dividends or assets, which have unlimited dividend rights;

(c) the term "voting rights" shall mean the right, not dependent on the happening of an event specified in the certificate of incorporation or in any other certificate filed pursuant to law which would change the voting rights of any class of stock, to vote for the election of one or more directors; and

(d) the term "voting shares" shall mean shares of any class which have voting rights.

(e) the term "preemptive rights" shall mean the rights to purchase shares or securities to be offered as such rights are hereinafter defined.

2. Except as otherwise provided in the certificate of incorporation or in any other certificate filed pursuant to law, and except as hereinafter provided, the holders of equity shares of any class, in case of the proposed issuance by the corporation of, or the granting by the corporation of options to purchase, its equity shares of any class or any shares, notes, debentures, bonds, or other securities convertible into or carrying options or warrants to purchase its equity shares of any class, shall if the issuance of the securities proposed to be issued, or the granting of options with respect thereto, would adversely affect the unlimited dividend rights of such holders, have the right during a reasonable time and on reasonable conditions, both to be fixed by the board of directors, and at a not less favorable price (without deduction of such reasonable compensation for the sale, underwriting or purchase of such shares by underwriters or dealers as may lawfully be paid by the corporation) than such shares or securities are

to be offered for sale to others, to purchase such shares or securities in the proportion determined as hereinafter provided.

3. Except as otherwise provided in the certificate of incorporation or in any other certificate filed pursuant to law, and except as hereinafter provided, the holders of voting shares of any class, in case of a proposed issuance by the corporation of, or the granting by the corporation of options to purchase, its voting shares of any class or any shares, notes, debentures, bonds or other securities convertible into or carrying options or warrants to purchase its voting shares of any class, shall, if such proposed issuance would adversely affect the voting rights of such holders, have the right during a reasonable time and on reasonable conditions, both to be fixed by the board of directors, and at a not less favorable price (without deduction of such reasonable compensation for the sale, underwriting or purchase of such shares by underwriters or dealers as may lawfully be paid by the corporation) than such shares or securities are to be offered for sale to others, to purchase such shares or securities in the proportion determined as hereinafter provided.

4. Unless otherwise provided in the certificate of incorporation or in any other certificate filed pursuant to law, shares or other securities offered for sale shall not be subject to preemptive rights if they

(a) are issued or optioned by the board of directors to effect a merger or consolidation or for a consideration other than cash;

(b) are issued to satisfy conversion or option rights theretofore granted by the corporation;

(c) are shares or other securities theretofore reacquired by the corporation after having been duly issued;

(d) are part of the shares or other securities of the corporation originally authorized in its certificate of incorporation and are issued, sold or optioned within two years from the date of filing such certificate; or

(e) are issued pursuant to a plan of reorganization approved under and in accordance with the provisions of the act of congress of July first, eighteen hundred ninety-eight, entitled "An act to establish a uniform system of bankruptcy throughout the United States," and acts amendatory thereof.

5. Holders of record of shares entitled to preemptive rights at the record time fixed by the board of directors pursuant to section sixty-two or if no such record time is fixed, then at the close of business on the fifth business day preceding the mailing of the notice provided for in subdivision six hereof and no others shall be entitled to the rights defined in this section. The preemptive right of each such holder to purchase the shares or securities to be offered shall be to purchase such shares or securities as nearly as practicable in such number as would, if such preemptive right were exercised, preserve the relative unlimited dividend rights and voting rights of such holder. In case each share entitled to preemptive rights does not have the same voting rights or the same unlimited dividend rights, the board

of directors shall apportion the shares or securities to be offered among the stockholders having preemptive rights to purchase them in such proportion as in the opinion of the board of directors shall preserve as far as practicable the relative unlimited dividend rights and voting rights of the holder at the time of such offering. The apportionment made by the board of directors shall, in the absence of fraud or bad faith, be binding upon all stockholders.

6. The board of directors shall cause to be mailed to each stockholder of record entitled to purchase shares or securities in accordance with this section, a notice directed to him in the manner provided in section forty-five, setting forth the time within which and the terms and conditions under which the stockholder may purchase such shares or securities and also the apportionment made of the right to purchase among the stockholders entitled to preemptive rights. Such notice shall be mailed at least fifteen days prior to the expiration of the period during which the stockholder shall have the right to purchase. All stockholders entitled to preemptive rights to whom notice shall have been mailed as aforesaid, shall be deemed conclusively to have had a reasonable time in which to exercise their preemptive rights.

7. Shares or securities which have been offered to stockholders having preemptive rights to purchase and which have not been purchased by them within the time fixed by the board of directors may thereafter, for a period of not exceeding one year following the expiration of the time during which stockholders might have exercised such preemptive rights, be issued, sold or optioned to any other person or persons at a price, (without deduction of such reasonable compensation for the sale, underwriting or purchase of such shares by underwriters or dealers as may lawfully be paid by the corporation) not less than that at which they were offered to such stockholders. Any such shares or securities not so issued, sold or optioned to others during such one year period shall thereafter again be subject to the preemptive rights of stockholders.

8. Except as provided in this section, or in the certificate of incorporation, or other certificate filed pursuant to law, no holder of any shares of stock of any class shall as such holder have any preemptive right to purchase any shares or securities of any class which at any time may be sold or offered for sale by the corporation. Nothing herein contained, however, shall be deemed to modify or affect the provisions of section fourteen.

9. The provisions of this section shall apply to all stock corporations now existing, as well as to those hereafter incorporated. If any provisions of this section or the application of any such provisions to any person or circumstance shall be held invalid, the remainder of this section and the application of such provision to persons or circumstances other than those as to which it is held invalid shall not be affected thereby.

See, supra, Delaware General Corporation Law, § 5(10).

NOTE

STOCKHOLDERS' PRE-EMPTIVE RIGHTS

An economic analysis of a share of stock shows that it is a bundle of rights. Among these are:

(1) The right to a share of the corporate assets on dissolution;

(2) The right to a share of the corporate earnings, if and when distributed by the board of directors;

(3) The right to vote; and

(4) The right to invest capital in the enterprise, if and when the directors shall so decide.

Any and all of these rights may be modified by the contract and constitutive documents.

Economically the preemptive right is the legal recognition of the last named, viz., the right to invest capital. This right becomes valuable when the enterprise has demonstrated that it will earn a higher rate of return on the capital than the stockholder could get on that capital were he to reinvest it in the open market. Thus, if the ruling rate of return on capital is 6 per cent, and he can invest it in a business which will yield 12 per cent., the right to invest capital in the enterprise precisely doubles the useful value of his capital.

Corporations which can continually use additional capital and have demonstrated their ability to earn a high rate of return on it are likely to be constantly seeking additional capital for investment. A notable instance is the American Telephone & Telegraph Co. which calls for roughly two hundred millions of additional capital every two years, and is able to earn approximately 12 per cent. thereon. A share of stock in that company, representing a contribution of $100 capital will often sell at once for $200 and better depending on market conditions. The right to subscribe for such a share is thus extremely valuable and is one of the recognized profitable features of that stock.

The same factor appears in successful investment trusts.

Only recently the value of this right to invest new capital has been recognized as the greatest reason for the preemptive right. Originally it was thought (see Gray v. Portland Bank, infra) that the right was intended to preserve the shareholders' aliquot voting position, and his ratable participation in the assets of the corporation. This was probably true at the time when the doctrine was propounded; for in 1803 public markets, as known today, were only in their infancy, and the value of the right to invest capital at a high rate of return was not instantly discounted by the stock market as it is, for instance, in the case of the American Telephone & Telegraph stock.

It should be noted also that one of the ways by which a corporate management secures additional power for itself is by inserting in the constitutive corporate documents clauses "waiving" or contracting away the preemptive right. Stock bought under such charters is apt to be worth less and to increase in value less swiftly, than stock issued under charters giving to the holder his full preemptive right. If the management is able to give to its associates or to outsiders the right to invest new capital at a demonstrated high rate of return, they have in their power an instrument of very considerable value.

GRAY v. PRESIDENT, DIRECTORS & COMPANY OF PORTLAND BANK.

Supreme Judicial Court of Massachusetts, 1807. 3 Mass. 364, 3 Am.Dec. 156.

[In 1799, certain men associated to incorporate a bank. All the shares to be issued were subscribed for when Gray, the plaintiff, was invited to become a subscriber. Seventy shares were allotted to Gray. The bank was then incorporated by legislative act, with an authorized capital of not less than $100,000 nor more than $300,000 of $100 par shares. 1,000 shares were issued, and Gray received certificates for seventy shares.

To meet the expense of purchasing a bank building, the stockholders voted to increase the capital stock to $300,000. Subscriptions to the new issue were to be offered to the "original subscribers to the bank and their associates, viz., those who associated with said original subscribers previous to the act of incorporation" at the rate of two shares for one.

Plaintiff tendered payment for his subscription to 140 shares of the new issue, but the corporation refused to issue the stock. He then brought an action on the case against the corporation for damages sustained by him due to the failure of the bank to issue the stock. The issue was whether plaintiff was an original subscriber or an associate. A verdict was rendered for plaintiff, subject to the opinion of the court on the facts reported by the trial judge.] * * *

SEDGWICK, J. [After reciting the history of the cause.] Upon these facts the counsel for the plaintiff contend—

1. That the plaintiff, as a stockholder of the old stock, at the time of the vote to augment the capital of the bank, had a right in the new stock, in proportion to the amount of his interest in the old stock, of which he could not rightfully be deprived by his partners, the other stockholders.

2. That, admitting it was competent to the stockholders, by the manner in which they prescribed the augmentation of their capital, to prevent him from becoming a subscriber to, and interested in, the new stock, they have not done it; but, on the contrary, have expressly, by their vote, authorized him to subscribe to the new, in proportion as he was interested in the old stock.

3. That the plaintiff, having offered to subscribe to the new stock, and to pay, as it became due, the amount of his subscription, and having been prevented from subscribing, and his payments having been refused by the agents and officers of the bank, he has sustained an injury.

4. That for this misconduct of its servants, the bank is responsible to the plaintiff.

5. That the plaintiff, having done everything incumbent on him to become a proprietor in the new stock, is interested in it, and consequently is entitled to his proportion of the dividends upon that stock.

All these propositions are denied by the counsel for the defendants. To determine on them will decide the merits of the case.

1. Then had the plaintiff, as a stockholder of the old stock, at the time of the vote to augment the capital of the bank, a right in the new stock, in proportion to his interest in the old stock, of which he might not rightfully be deprived by his partners, the other stockholders? I think that he had.

At the time of the vote to augment the capital of the bank, all the stockholders were partners. The augmentation was supposed to be, and intended for the profit of the joint concern; the capacity to augment was in virtue of their joint interest; and it could only be done by the will of the majority, and that in pursuance of their original association. The law, by which the partnership existed, and by which the united interest was regulated, was that alone by which the augmentation could be made. Whenever a partnership adopts a project, within the principles of their agreement, for the purpose of profit, it must be for the benefit of all the partners, in proportion to their respective interests in the concern. Natural justice requires that the majority should not have authority to exclude the minority. What is there in this case which should make it an exception from that general principle? There is nothing, that I can perceive, in the reason and nature of the thing. Suppose it to have been morally certain, that the augmentation would have been double in value, to the amount of the money necessary to make it; could a combination of a majority have deprived the minority of their proportion? The whole number of shares was one thousand; could the proprietors of five hundred and one have engrossed the whole, and deprived their partners of their share? It is impossible.

At the time of the vote to augment the capital, a banking-house had been purchased, and become the property of the institution. In this Mr. Gray was personally interested, in proportion as his interest in the bank was to the amount of the whole stock. After the capital is increased, the banking-house is, as it was before, the joint property of the stockholders; and the consequence of excluding him from the new stock without any compensation, is depriving him, without any consideration, of two thirds part of his property in this house. This shows, in a very glaring light, how unfounded is the principle for which the defendants contend.

2. By the terms of the vote designating those who should be authorized to subscribe to the new stock, the case of Mr. Gray is expressly included. He was an associate with the original subscribers, or an assignee of them, previous to the act of incorporation. This is evident from the application by those concerned to his agents; from his being furnished with the shares in the manner detailed in the evidence; from the notice which was issued to him, to pay his proportion of the capital; and from the certificates of ownership which were afterwards issued to him as a proprietor. So that if it was competent to the stockholders, as they say, to decide who should be interested in the new stock, and be authorized to subscribe to it, the plaintiff had undoubtedly the right which he claimed, and which he says

has been violated. How this could have been misunderstood by the committee and officers of the bank, is, from the evidence given at the trial, to my mind, perfectly unaccountable. I do not, however, mean to accede to the practical exposition, which the corporation claimed by their vote, of excluding any of the stockholders from subscribing, if they pleased, to the new stock; but, from what has been said, I think it evident that, from any view that can be taken of the subject, Mr. Gray had a right to subscribe to the new stock. From hence it follows—

3. That the plaintiff, having offered to subscribe to the new stock, and to pay, as it became due, the amount of his subscription; and having been prevented from subscribing, and his payments having been refused by the agents and officers of the bank, he has thereby sustained an injury.

4. The plaintiff says that the bank is responsible to him for that misconduct of its agents and officers, of which he complains; and I think the position a correct one. That principals and masters should be responsible, civiliter, for the misconduct, negligence, and defaults of their agents and servants, while acting under the authority delegated to them, is indispensable to the security of the rights and property of all, who may be affected by such misconduct, negligence or default. This principle, the justness of which all must readily perceive, has been so frequently recognized in courts of justice, that a reference to authorities is deemed superfluous. I will, however, repeat what is said by Mr. Christian, in his notes on Blackstone's commentaries, as the reason on which this principle of law rests. "The law," he says, "which obliges masters to answer for the negligence and misconduct of their servants, though oftentimes severe upon an innocent person, is founded upon principles of public policy, in order to induce masters to be careful in the choice of their servants, upon which both their own security and that of others so greatly depends." In no case is this principle of so much importance as in the relation of corporations to their servants; because, in innumerable instances, they cannot act but by their agents, and there would be no security for those who might be affected by the acts of the agents, if they should abscond or be insolvent. This shows how improper it would be, as contended for by the counsel for the defendants, to oblige one, injured in this way, to resort for his remedy to the agent. * * * [61]

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[61] Berle, Corporate Powers as Powers in Trust, 1931, 44 Harv.L.Rev. 1049, 1056; Drinker, The Preemptive Right of Shareholders to Subscribe to New Shares, 1930, 43 Harv.L.Rev. 586, 590; Dwight, Rights of Stockholders to New Stock, 1908, 18 Yale L.J. 101, 102.

STOKES v. CONTINENTAL TRUST CO. OF CITY OF NEW YORK.

Court of Appeals of New York, 1906. 186 N.Y. 285, 78 N.E. 1090.

Appeal from an order of the Appellate Division of the Supreme Court in the first Judicial Department, entered January 4, 1905, reversing a judgment in favor of plaintiff entered upon a decision of the court on trial at Special Term and granting a new trial.

This action was brought by stockholder to compel his corporation to issue to him at par such a proportion of an increase made in its capital stock as the number of shares held by him before such increase bore to the number of all the shares originally issued, and in case such additional shares could not be delivered to him for his damages in the premises.

The defendant is a domestic banking corporation in the city of New York, organized in 1890, with a capital stock of $500,000, consisting of 5,000 shares of the par value of $100 each. The plaintiff was one of the original stockholders, and still owns all the stock issued to him at the date of organization, together with enough more acquired since to make 221 shares in all. On the 29th of January, 1902, the defendant had a surplus of $1,048,450.94, which made the book value of the stock at that time $309.69 per share. On the 2d of January, 1902, Blair & Co., a strong and influential firm of private bankers in the city of New York, made the following proposition to the defendant: "If your stockholders at the special meeting to be called for January 29th, 1902, vote to increase your capital stock from $500,000 to $1,000,000 you may deliver the additional stock to us as soon as issued at $450 per share ($100 par value) for ourselves and our associates, it being understood that we may nominate ten of the 21 trustees to be elected at the adjourned annual meeting of stockholders." * * * A resolution to increase the stock was adopted by the vote of 4,197 shares, all that were cast. Thereupon the plaintiff demanded from the defendant the right to subscribe for 221 shares of the new stock at par, and offered to pay immediately for the same, which demand was refused. A resolution directing a sale to Blair & Co. at $450 a share was then adopted by a vote of 3,596 shares to 241. The plaintiff voted for the first resolution, but against the last, and before the adoption of the latter he protested against the proposed sale of his proportionate share of the stock, and again demanded the right to subscribe and pay for the same, but the demand was refused.

On the 30th of January, 1902, the stock was increased, and on the same day was sold to Blair & Co. at the price named, although the plaintiff formally renewed his demand for 221 shares of the new stock at par, and tendered payment therefor, but it was refused upon the ground that the stock had already been issued to Blair & Co. Owing in part to the offer of Blair & Co. which had become known to the public, the market price of the stock had increased from $450 a share in September, 1901, to $550 in January, 1902, and at the time of the trial, in April, 1904, it was worth $700 per share. * * *

After finding these facts in substance, the trial court found, as conclusion of law, that the plaintiff had the right to subscribe for such proportion of the increase, as his holdings bore to all the stock before the increase was made; that the stockholders, directors, and officers of the defendant had no power to deprive him of that right, and that he was entitled to recover the difference between the market value of 221 shares on the 30th of January, 1902, and the par value thereof, or the sum of $99,450, together with interest from said date. The judgment entered accordingly was reversed by the Appellate Division, and the plaintiff appealed to this court, giving the usual stipulation for judgment absolute in case the order of reversal should be affirmed.

VANN, J. (after stating the facts). * * * Thus the question presented for decision is whether according to the facts found the plaintiff had the legal right to subscribe for and take the same number of shares of the new stock that he had held of the old?

The subject is not regulated by statute, and the question presented has never been directly passed upon by this court, and only to a limited extent has it been considered by courts in this state. * * *

If the right claimed by the plaintiff was a right of property belonging to him as a stockholder, he could not be deprived of it by the joint action of the other stockholders, and of all the directors and officers of the corporation.

In the case before us the new stock came into existence through the exercise of a right belonging wholly to the stockholders. As the right to increase the stock belonged to them, the stock when increased belonged to them also, as it was issued for money and not for property or for some purpose other than the sale thereof for money. By the increase of stock the voting power of the plaintiff was reduced one-half, and while he consented to the increase he did not consent to the disposition of the new stock by a sale thereof to Blair & Co. at less than its market value, nor by sale to any person in any way except by an allotment to the stockholders. The increase and sale involved the transfer of rights belonging to the stockholders as part of their investment. The issue of new stock and the sale thereof to Blair & Co. was not only a transfer to them of one-half the voting power of the old stockholders, but also of an equitable right to one-half the surplus which belonged to them. In other words, it was a partial division of the property of the old stockholders. The right to increase stock is not an asset of the corporation any more than the original stock when it was issued pursuant to subscription. The ownership of stock is in the nature of an inherent but indirect power to control the corporation. The stock when issued ready for delivery does not belong to the corporation in the way that it holds its real and personal property, with power to sell the same, but is held by it with no power of alienation in trust for the stockholders, who are the beneficial owners, and become the legal owners upon paying therefor. The corporation has no rights hostile to those of the stockholders, but is the trustee for all including the minority. The new stock issued by the defendant under the permission of the statute did not belong to it, but was held by it the same as the original stock when first issued was held in trust for the stockholders.

It has the same voting power as the old, share for share. The stockholders decided to enlarge their holdings, not by increasing the amount of each share, but by increasing the number of shares. The new stock belonged to the stockholders as an inherent right by virtue of their being stockholders, to be shared in proportion upon paying its par value or the value per share fixed by vote of a majority of the stockholders, or ascertained by a sale at public auction. While the corporation could not compel the plaintiff to take new shares at any price, since they were issued for money and not for property, it could not lawfully dispose of those shares without giving him a chance to get his proportion at the same price that outsiders got theirs. He had an inchoate right to one share of the new stock for each share owned by him of the old stock, provided he was ready to pay the price fixed by the stockholders. If so situated that he could not take it himself, he was entitled to sell the right to one who could, as is frequently done. Even this gives an advantage to capital, but capital necessarily has some advantage. Of course, there is a distinction when the new stock is issued in payment for property, but that is not this case. The stock in question was issued to be sold for money and was sold for money only. A majority of the stockholders, as part of their power to increase the stock, may attach reasonable conditions to the disposition thereof, such as the requirement that every old stockholder electing to take new stock shall pay a fixed price therefor, not less than par, however, owing to the limitation of the statute. They may also provide for a sale in parcels or bulk at public auction, when every stockholder can bid the same as strangers. They cannot, however, dispose of it to strangers against the protest of any stockholder who insists that he has a right to his proportion. Otherwise the majority could deprive the minority of their proportionate power in the election of directors and their proportionate right to share in the surplus, each of which is an inherent, pre-emptive, and vested right of property. It is inviolable, and can neither be taken away nor lessened without consent, or a waiver implying consent. The plaintiff had power, before the increase of stock, to vote on 221 shares of stock, out of a total of 5,000, at any meeting held by the stockholders for any purpose. By the action of the majority, taken against his will and protest, he now has only one-half the voting power that he had before, because the number of shares has been doubled while he still owns but 221. This touches him as a stockholder in such a way as to deprive him of a right of property. Blair & Co. acquired virtual control, while he and the other stockholders lost it. We are not discussing equities, but legal rights, for this is an action at law, and the plaintiff was deprived of a strictly legal right. If the result gives him an advantage over other stockholders, it is because he stood upon his legal rights, while they did not. The question is what were his legal rights, not what his profit may be under the sale to Blair & Co., but what it might have been if the new stock had been issued to him in proportion to his holding of the old. The other stockholders could give their property to Blair & Co., but they could not give his.

A share of stock is a share in the power to increase the stock, and belongs to the stockholders the same as the stock itself. When that

power is exercised, the new stock belongs to the old stockholders in proportion to their holding of old stock, subject to compliance with the lawful terms upon which it is issued. When the new stock is issued in payment for property purchased by the corporation, the stockholders' right is merged in the purchase, and they have an advantage in the increase of the property of the corporation in proportion to the increase of stock. When the new stock is issued for money, while the stockholders may provide that it be sold at auction or fix the price at which it is to be sold, each stockholder is entitled to his proportion of the proceeds of the sale at auction, after he has had a right to bid at the sale, or to his proportion of the new stock at the price fixed by the stockholders.

We are thus led to lay down the rule that a stockholder has an inherent right to a proportionate share of new stock issued for money only and not to purchase property for the purposes of the corporation or to effect a consolidation, and while he can waive that right, he cannot be deprived of it without his consent except when the stock is issued at a fixed price not less than par, and he is given the right to take at that price in proportion to his holding, or in some other equitable way that will enable him to protect his interest by acting on his own judgment and using his own resources. This rule is just to all and tends to prevent the tyranny of majorities which needs restraint, as well as virtual attempts to blackmail by small minorities which should be prevented.

The remaining question is whether the plaintiff waived his rights by failing to do what he ought to have done, or by doing something he ought not to have done. * * * By selling to strangers without thus offering to sell to him, the defendant wrongfully deprived him of his property, and is liable for such damages as he actually sustained.

The learned trial court, however, did not measure the damages according to law. The plaintiff was not entitled to the difference between the par value of the new stock and the market value thereof, for the stockholders had the right to fix the price at which the stock should be sold. They fixed the price at $450 a share, and for the failure of the defendant to offer the plaintiff his share at that price we hold it liable in damages. His actual loss, therefore, is $100 per share, or the difference between $450, the price that he would have been obliged to pay had he been permitted to purchase, and the market value on the day of sale, which was $550. This conclusion requires a reversal of the judgment rendered by the Appellate Division and a modification of that rendered by the trial court.

The order appealed from should be reversed and the judgment of the trial court modified by reducing the damages from the sum of $99,450, with interest from January 30, 1902, to the sum of $22,100, with interest from that date, and by striking out the extra allowance of costs, and as thus modified the judgment of the trial court is affirmed, without costs in this court or in the Appellate Division to either party. * * * [62]

[62] Drinker, The Preemptive Right of Shareholders to Subscribe to New Shares, 1930, 43 Harv.L.Rev. 586, 593; Dwight, Rights of Stockholders to New Stock,

WALL v. UTAH COPPER COMPANY

Court of Chancery of New Jersey, 1905. 70 N.J.Eq. 17, 62 A. 533.

[Defendant, Utah Copper Company, a New Jersey corporation, had an authorized, issued capital stock of $4,500,000. Complainant Wall, one of seven directors and the largest individual stockholder, held 90,000 ($900,000 par value) shares in the company. Defendants MacNeill and Penrose, directors, were the next largest stockholders.

In 1905, to exploit defendant's property, MacNeill and Penrose contracted with Guggenheim Exploration Company, also a New Jersey corporation. The agreement provided: (1) Utah Copper Co. was to issue $3,000,000 of $1,000 par value bonds, payable in 10 years at 6% interest, secured by a mortgage to the Morton Trust Co.; the bonds to be convertible at the holders' option at any time within five years, into 50 shares of $10 par value stock of Utah Copper Co.; (2) $1,500,000 of new stock was to be issued to provide for the possible conversion of the bonds; (3) Guggenheim Exploration Co. was to be given the right to take the entire bond issue at ninety-eight cents on the dollar; (4) Guggenheim Exploration Co. was given an option to buy 156,000 shares of $10 par stock at $20 per share from MacNeill and Penrose; (5) MacNeill and Penrose were given the right and option to take one-half the entire bond issue on their own account on condition that if they converted the bonds into stock, they would sell part of such stock to Guggenheim Exploration Co. at $20 per share.

Guggenheim Exploration Co. might thus become the owner of $3,600,000 of the capital stock of Utah Copper Co., giving it a majority of the entire stock issue of $6,000,000.

A directors' meeting was called to consider a proposed contract between Utah Copper Co. and Guggenheim Exploration Co. which made no reference to the private arrangements between MacNeill, Penrose and Guggenheim Exploration Co., but incorporated provisions relating to the bond issue and the increase of stock for conversion purposes. The directors adopted this contract subject to ratification by the stockholders. Plaintiff was unable to attend this meeting, but objected in writing to the proposed agreement.

A stockholders' meeting was called for September 5, 1905. Wall, on receiving the notice of meeting, protested to MacNeill, and was then told that he would lose his preemptive right to subscribe to the new stock issue unless he agreed to give a purchase option of 51% of his stock holdings at $19.60 per share to American Smelters Security Co.

1908, 18 Yale L.J. 101, 104; Notes, 1907, 20 Harv.L.Rev. 398, 1907, 16 Yale L.J. 194.

On stockholders' pre-emptive rights to new issues of stock, see Berle and Means, The Modern Corporation and Private Property, 1932, 144–146, 255–260; Briggs, Some Legal Aspects of Stock Rights, 1932, 6 Temp.L.Q. 221; Drinker, The Preemptive Right of Shareholders to Subscribe to New Shares, 1930, 43 Harv.L.Rev. 586; Dwight, Rights of Stockholders to New Stock, 1908, 18 Yale L.J. 101; Frey, Shareholders' Preemptive Rights, 1929, 38 Yale L.J. 563; Morawetz, The Preemptive Right of Shareholders, 1928, 42 Harv.L.Rev. 186; Notes, 1928, 52 A.L.R. 220, 1913, 33 Col.L.Rev. 146, 1933, 11 N.Y.U.L.Q.Rev. 78, 1941, 15 Temp.L.Q. 287.

Wall sent an attorney to the stockholders' meeting and submitted a written protest to the ratification of the contract providing for the bond issue and increase of stock. Apparently the contract was approved in spite of his objections.

On September 11, Wall brought a bill to restrain the bond issue. On order to show cause why the injunction should not issue, argument was had and the following opinion rendered:]

PITNEY, V. C. (after stating the facts). * * * The last and most serious objection urged by complainant is that the proposed action will deprive him of a clear and indisputable right which he has by the law of the land to participate in any issue of new stock to an extent measured by the comparative amount of his present holdings of stock, and upon the same terms that other parties shall participate therein. In other words, that he is entitled to an opportunity to take and pay for one-fifth of the proposed new issue, and that the contract to dispose of all that issue to the exploration company infringes on that right.

This right, as I understand it, is based on two grounds.

First. That the complainant became the owner of one-fifth of the property of this corporation with the full understanding that he would thereby have a voice and influence in its management due, among other things, to that share, and that an increase of the stock issued to other people will diminish his voice and influence just so much.

Second. That at present he is entitled by law to one-fifth of the whole property of the corporation, whatever may be its value, and he is entitled to one-fifth of any increase of that value, whether such increase be due to the accumulation of actual earnings or to anticipated increase as the effect of the knowledge, by physical development, of its present value, and any issue of capital stock is of necessity a diminution of his share in that increase, and that in order to protect him against an undervaluation of the new stock to be issued, however that undervaluation may arise, he is entitled to the privilege of taking a proportionate share of the new stock, and especially is he so entitled in the present case, where there is no present sale of the new stock at an appraised value, but where an option is given to purchase at any time within five years, at a price now fixed, and which, when the option comes to be exercised, may prove to be entirely inadequate. Thus the holder of the option will have the whole of five years, during which the mining property is being developed, to ascertain and determine whether it is worth while for it to exercise its option. If the property does not improve in value and the stock is not worth $20 per share, it will not exercise its option, but will enforce the payment of the bond. If, on the other hand, the property does, either by its development or by the addition of undivided earnings, increase in value so as to be worth, as it may, many times the price fixed, it will exercise its option, and in such case it will gain at the expense and loss of the complainant.

The complainant's contention is, in my judgment, thoroughly based upon justice and law. * * *

For the reasons above set forth, I am of the opinion that the last objections taken by the complainant to these proceedings is fatal, and, without expressing any opinion upon the other objections made, that an injunction must go until the time of the hearing.[63]

MEREDITH et al. v. NEW JERSEY ZINC & IRON COMPANY.

Court of Chancery of New Jersey, 1897.
55 N.J.Eq. 211, 37 A. 539, affirmed 56 N.J.Eq. 454, 41 A. 1116.

PITNEY, V. C. The complainants are, severally, the owners of certain shares of stock in the New Jersey Zinc and Iron Company, and seek by their bill to enjoin the performance of a contract entered into by that company with the other defendants. * * *

[The New Jersey Zinc Company was organized in New Jersey in 1880 to carry on the mining, manufacturing and sale of ores in New Jersey and New York City. It had a capital stock of $3,040,000 of $100 par shares. Complainants held 291 shares. The contract whose performance is sought to be enjoined was approved by eight-tenths of the stockholders at a meeting called for the purpose.]

The defendant the New Jersey Zinc and Iron Company and the defendant the Hardyston Mining Company, very recently successor in title to the defendant the Lehigh Zinc and Iron Company, are severally the owners of certain mineral rights situate at a place called Mine Hill, in the Wallkill valley, in the county of Sussex. The mineral which they own is called franklinite and contains zinc, and its value consists in the presence of that mineral in it. It was discovered some fifty or sixty years ago, and when first discovered, and before the lodes or veins in which it was found were developed, it was supposed that there were two distinct minerals so situate that they could be separately owned and mined, namely, zinc and franklinite, the latter a peculiar mixture of mineral substances which takes its name from the village of Franklin, near which the veins are situate. Based upon this supposition, the titles to the two different minerals found in the same lodes or veins, at the place here in question, were separated. The right to mine the zinc ore was sold by itself, and the right to mine the franklinite ore was sold by itself.

But when an attempt was made to define and separate, in practice, the two ores in the earth, it was found that it was practically impossible and a serious dispute at once arose whether the various veins or portions of veins which were uncovered were franklinite or zinc.

This state of things has led to a series of litigations in the state and federal courts, with varying results, which, I may here say, were not at all referred to in the bill, but in argument counsel for de-

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63 1906, 6 Col.L.Rev. 359; 1906, 4 Mich.L.Rev. 554.

See Note, 1906, 6 Col.L.Rev. 184, on whether a dissenting stockholder may restrain the issue of convertible bonds below par.

For a discussion of preemptive rights to convertible securities, and convertible securities in general, see Hills, Convertible Securities—Legal Aspects and Draftsmanship, 1930, 19 Calif.L.Rev. 1, esp. 1-12.

fendants relied, and I think properly, upon the common knowledge of the bench and bar of this state, derived from the official reports of the various suits, for a history of this controversy.

Before adverting to those reports it is proper to say that the defendant the New Jersey Zinc and Iron Company is the successor in title to the New Jersey Zinc Company, organized under a special charter about the middle of the century, and which became entitled to the "zinc" ore in the tract called Mine hill.

The title to the "franklinite" in a district known as the south half of Mine hill became vested in one party, and that of the franklinite in the north half became vested in another party.

The first suit was between the old New Jersey Zinc Company and the owner of the franklinite on the south half, and that resulted, first, in a victory for the franklinite company, as reported in New Jersey Zinc Co. v. New Jersey Franklinite Co., 13 N.J.Eq. 322. That decision was reversed, on appeal, in New Jersey Zinc Co. v. Boston Franklinite Co., 15 N.J.Eq. 418, and the title to both ores in effect apparently vested in the zinc company. That was in 1862.

Under that decision the old zinc company prosecuted its business upon the south half of Mine hill until some time in the next decade, when a party holding an unsatisfied mortgage on the franklinite in the south half, who was not a party to the previous litigation, foreclosed his mortgage, obtained the title and commenced a suit in the federal court against the New Jersey Zinc Company, which resulted adversely to that company. The result of that litigation was that the present New Jersey Zinc and Iron Company was organized, and the two warring titles to the franklinite and the zinc ores were conveyed to the new company, whereby it became the undisputed owner of all the ores in the south half of Mine hill and of the zinc ores on the north half.

In the meantime the franklinite on the north half became vested in the Lehigh Zinc and Iron Company, and about nine years ago the New Jersey Zinc and Iron Company commenced suit against the Lehigh Zinc and Iron Company to establish its title to the north half, which suit, with varying fortunes in the courts, was finally decided against the New Jersey Zinc and Iron Company in November, 1896.

This decision, however, covered only a part of the north half of the hill. Another undeveloped vein of the ore still remained unaffected by the decision.

In this state of things negotiations were entered into between the parties for the purpose of settling the litigation by the purchase by one party or the other of the opposite interests. * * *

The sworn statement of the president of the New Jersey Zinc and Iron Company is to the effect that the situation of affairs was such that it was found impracticable to effect a settlement of the controversy arising out of the difficulties in the title without buying up all of these works. With that view the contract in question was entered into, which was preliminary in its nature and depended upon the results of an investigation of the titles of all the properties and

of the value in particular of the mines in Sussex county. Eminent experts, entirely indifferent between the parties, were chosen to appraise their value, and fixed them at a very high figure.

The price to be paid by the New Jersey Zinc and Iron Company for all these properties was (roughly) $1,250,000 in cash and the issue of thirty-two thousand nine hundred and thirty-four shares of stock, of $3,293,400 par value, to be distributed among the different owners.

The Lehigh Zinc and Iron Company and its appendages, including the Hardyston company, are owned almost entirely by four indivi-uals—Messrs. Richard and August Heckscher and S. P. and J. P. Wetherill. The Wetherills also own certain interests in some patent rights which pass with the sale.

In order to legitimatize the future operations of the company at points outside of the state and to make the necessary increase of capital stock, the same meeting of stockholders, which by a vote of about eight-tenths of the whole approved the contract, approved a change in the certificate of organization, by which the company was enabled to mine and manufacture outside the state and to buy and hold stocks &c. and to increase its capital stock.

This exposition of the circumstances and real objects of the contract is made so that the objections urged by the complainants may be the better understood. They are as follows: * * *

Third. The manner of increasing and distributing the increased capital stock is objected to, the particular ground of this last objecting being that any increase of capital stock must be divided among the present holders of stock in proportion to their holdings. * * *

The only point made in that connection was that when a block of increased stock is issued, each of the old holders is entitled to such a proportion of it as his holdings bore to the whole amount of stock before the increase, and that complainants' rights in that behalf are about to be invaded.

At the argument, counsel for defendants offered to the complainants to insure to them the right to purchase at par such proportion of the new stock as they would be entitled to under the rule relied upon.

By casting out of view that offer, two answers are made to the objection by the defendants—first, that the fifty-fifth section[64] authorizes the issuing of stock for the purchase of property, and that that section, which must also be read into the contract between the stockholders, overrides the general rule invoked; and second, that the general rule (if there be such) requiring an equal distribution of new stock was adopted by the courts for the purpose of preventing any particular stockholders or clique of stockholders from appropriating to themselves the right to subscribe to new stock at par when such privilege is worth a premium.[65] 2 Beach Priv.Corp. § 473;

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[64] N.J.Corporation Act 1875, § 55, deals with the issue of stock for property. N.J.Rev.Laws 1877 (Corporation Act 1877) p. 187, § 55, provides that directors may issue stock in payment for property.

Cf. N.J.S.A. § 14:8–9, *infra*, p. 370, f. n. 80.

[65] The following remarks by Pitney, V. C., in Wall v. Utah Copper Co., *supra*,

Gray v. President, etc., of Portland Bank, 3 Mass. 364, 3 Am.Dec. 156. In the case in hand, as the stock is issued for the purchase of property which will become a part of the common property, and from which the dissenting stockholder will receive the same benefit, if any, as each of his associates, I can see no reason for the application of the rule in this case. The amount of stock to be issued to the parties interested in the properties to be conveyed was fixed upon the basis of their actual value.

The parties dealt at arm's length, and, as before observed, there is no reason to suspect that there is here the least element of a party making a contract with himself. Besides, it is well held in such cases that in case the corporation deprives a stockholder of his rights in this behalf, it is liable to an action at law for damages, and there is no suggestion that the zinc company is not of sufficient responsibility to answer to such action.

For these reasons, I think the complainants are not entitled to relief on that ground.

* * * I shall advise that the application for an order of restraint be denied.[66]

NOTES

(A) Although normally no pre-emptive right exists to subscribe to treasury stock, if the corporate directors, in breach of their fiduciary relation to stockholders, issue treasury shares to themselves, a preemptive right may arise. Hammer v. Werner, 239 App.Div. 38, 265 N.Y.S. 172, 2d Dep't., 1933; Note, 1933, 71 N.Y.U.L.Q. Rev. 78; 1934, 3 Brooklyn L.Rev. 337; 1933, 32 Mich.L.Rev. 110; 1933, 8 St. John's L.Rev. 153; 1934, 1 U. of Chi.L.Rev. 645.

(B) Even where stockholders are barred from pre-emptive rights by statute, they nevertheless have the right to demand that corporate directors do not use their position for their own personal advantage nor to cause stock to be issued to themselves to make a profit or obtain or retain control of the corporation. Schwab et al. v. Schwab-Wilson Machine Corporation, Ltd., et al., 13 Cal.App.2d 1, 55 P.2d 1268, 1936.

THOM v. BALTIMORE TRUST CO.

Court of Appeals of Maryland, 1930. 158 Md. 352, 148 A. 234.

URNER, J. The inquiry in this case is whether the appellants, as stockholders of the Baltimore Trust Company, were entitled to exercise the right to purchase a due proportion of a supplemental issue

p. 343, are significant in considering the Meredith Case,—"Against this doctrine defendants rely on the case of Meredith v. New Jersey Zinc & Iron Co., 55 N.J.Eq. 211, 37 A. 539, decided by myself, and affirmed on appeal, 56 N.J.Eq. 454, 41 A. 1116, on my opinion. What is expressly relied upon is found upon page 220 of 55 N.J. Eq., 37 A. 542, and counsel seem to think that the interpolation of the words in parentheses, 'if there be such,' after the words 'general rule,' manifested a doubt in my mind as to its existence. It is proper for me to say here that what I there said was the result of not more than ten minutes of consideration, and the only study given to the question was the reading of the section referred to in 2 Beach Corp. And if I had then had at command time to give the subject proper consideration, I am not at all sure that I should have dictated the sentence which immediately follows the citation of the Massachusetts case, which was not necessary for the decision of the cause."

66 Aff'd, without opinion, 56 N.J.Eq. 454, 41 A. 1116, 1898.

of its capital stock. It was held by the lower court that such a pre-emptive right would exist if the new shares had been intended to be sold for cash, but, that, as they were to be issued in payment for property, consisting of the stock of the National Union Bank of Maryland, the asserted right was not enforceable. The appeals are from an order and a decree effectuating that conclusion.

The case was heard on bill and answer, and from the pleadings and exhibits we learn the controlling facts, which may be briefly stated. At a meeting of stockholders of the Baltimore Trust Company, held after legal notice, approval was given, by the holders of more than two-thirds of its outstanding shares, to a plan recommended by its directors to merge its interests with those of the National Union Bank of Maryland. According to the plan, as submitted and adopted, the trust company would issue 15,000 shares of its stock, at a valuation of $112 per share, for the purpose of acquiring the 10,000 shares of the National Union Bank stock at a valuation of $168 per share. The contract to that end between the representatives of the two institutions was to be consummated only in the event that at least 70 per cent. of the bank stock could be delivered upon the agreed terms. The requisite increase of the trust company's capital stock was authorized by a charter amendment duly adopted by its stockholders. A contemporaneous amendment of the charter provided: "Upon any increased issue of stock, the stockholders shall have the pro rata preferential right to subscribe therefor at such price and on such terms as the Board of Directors may in each instance fix. In the event of the issue of any additional stock of the Company for the purpose of accomplishing the merger with or of acquiring any other bank or trust company or other property, the Directors may issue said stock without preferential subscription rights to stockholders or with preferential subscription rights to such extent and on such terms as the Board may in each instance deem proper." As the owner of 6,416 of the 70,000 shares of the trust company's capital stock, the plaintiffs voted and protested against the merger agreement, and the use of the proposed new issue of stock for the exchange purposes contemplated, which involved a disregard of the privilege of proportional purchase upon which the plaintiffs insisted. All of the 10,000 shares of the National Union Bank stock were in fact made available for delivery to the trust company upon the merger terms, and the whole of the new issue of 15,000 shares of the trust company's stock was required for the acquisition of the bank stock at the valuations specified in the agreement for the exchange.

The right of pre-emption claimed by the plaintiffs is said to be inherent in their stock ownership, and also to be conferred by the charters of certain corporations from the consolidation of which the Baltimore Trust Company derived its existence and the powers it possessed at the period when the merger with the National Union Bank was being negotiated. As then constituted, the Baltimore Trust Company owed its origin to the union of two corporations, one of which had been formed as the result of an earlier consolidation.

The charter of one of the constituent companies participating in the last consolidation made no provision for a pre-emptive right of stockholders with respect to additional issues of stock, and neither of the consolidation agreements made any reference to such a privilege. It was accorded in the charters of the two corporations which united under the first consolidation, but in one there was an important limitation, which the other did not contain, in regard to the exercise of the right. If the holders of stock of the Baltimore Trust Company, into which the stock of the constituent corporations was converted in pursuance of the consolidation, were entitled to refer to the charters of the former companies for the ascertainment of their rights, it would be impossible to find in those charters any support for the preemptive option as exercisable equally by all owners of the present company's stock. The effect of the successive consolidations was to end the existence of the constituent corporations and to vest in the new corporation all of their property, powers, and liabilities (Code, art. 23, § 34; Diggs v. Fidelity & Deposit Co., 112 Md. 72, 75 A. 517, 20 Ann.Cas. 1274), and, while consistent privileges of stockholders conferred by the superseded charters may presumably continue as incidents of the consolidated stock ownership, there could be no such survival of rights traceable to only one of the charters, or subject in one to a special limitation, because the uniform and equal recognition of the right in all the stockholders of the consolidated company is impossible, under such conditions, so far as any charter origin of the right is concerned.

Independently of the charters, however, the stockholders of a corporation have a preferential right to purchase new issues of its shares, to the proportional extent of their respective interests in the capital stock then outstanding, when the privilege can be exercised consistently with the object which the disposition of the additional stock is legally designed to accomplish. The right inheres in stock ownership as an essential means of enabling a stockholder to maintain the existing ratio of his proprietary interest and voting power in the corporation. It is an option which is capable of practical and useful exercise when new stock is to be issued for money needed to increase the company's cash assets. To that extent the right is well recognized, but to such stock issues it is generally restricted. In transactions involving the acquisition of property by corporations in exchange for shares of their stock, the determining consideration to the owners of the property may be the advantage of sharing as stockholders in the profits of the corporation with which they are contracting. In the present case every stockholder of the National Union Bank, for each of his shares of the stock of that institution, was to receive one and one-half shares of Baltimore Trust Company stock. It would not be feasible to consummate a transfer based upon such a consideration if the pre-emptive right asserted in this suit were to be held enforceable with respect to every new issue of stock regardless of the object of its disposition. Within the limits just indicated, the pre-emptive rights of the plaintiffs and other stockholders of the Baltimore Trust Company are recognized and protected

by the new charter amendment which we have quoted. In declaring the right as to sales of stock for cash, and in restricting it as to issues of stock for accomplishing a merger or acquiring property, the amendment is in valid accord with the principles we have stated, which have adequate support in reason and authority. * * *

As our conclusion agrees with that of the lower court, we shall affirm its decree dismissing the bill of complaint.

Order and decree affirmed, with costs. [67]

ARCHER v. HESSE.

Supreme Court of New York, Appellate Division, First Department, 1914.
164 App.Div. 493, 150 N.Y.S. 296.

[The board of directors of a domestic corporation voted to issue 197 shares of its preferred stock to Hesse, a director. Plaintiff, Archer, on behalf of himself and all other stockholders, brought an action against the company and its directors to have the resolution declared void and the stock so issued cancelled and surrendered. Judgment was rendered for plaintiff, directing Hesse to surrender his shares for cancellation. The company then had 197 shares of its authorized preferred stock unissued.

The directors adopted a resolution authorizing the issuance of 55 shares of preferred stock to attorneys, McCorkle and Bayne, for services rendered to the corporation and its directors in the cancellation proceeding. Certificates were issued and delivered.

Plaintiff obtained an order to show cause why the directors and the lawyers should not be punished for contempt of court for issuing, delivering and accepting the stock certificates. Defendants were adjudged guilty of contempt and directed to surrender and have cancelled the shares. From this order, the present appeal is taken by defendants.]

McLAUGHLIN, J. (after stating the facts). * * * But it is urged that the issuance of the stock to McCorkle and Bayne was unlawful, and, therefore, the order may be sustained upon that ground. What is claimed in this respect is that such stock was "unissued authorized capital stock of the company and before it could be issued lawfully every existing stockholder of the company was entitled to an opportunity to subscribe to it in such proportions as the stock he then held bore to the total amount of stock then outstanding." I do not understand this to be a correct statement of the law. A corporation may use its original unissued authorized capital stock for any legitimate or lawful purpose it sees fit, and the authorities cited are not to the contrary. Stokes v. Continental Trust Co., 186 N.Y. 285, 78

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[67] 1930, 30 Col.L.Rev. 569; 1930, 39 Yale L.J. 905; 1930, 78 U. of Pa.L.Rev. 1026. See Frey, Shareholders' Pre-emptive Rights, 1929, 38 Yale L.J. 563.

A certificate of incorporation may be amended to deprive consenting stockholders of their pre-emptive rights to new stock issued for money but such an amendment is not binding on any dissenting stockholder. Albrecht, Maguire & Co., Inc. v. General Plastics, Inc., and others, 256 App.Div. 134, 9 N.Y.S.2d 415, 4th Dep't., 1939 aff'd without opinion, 280 N.Y. 840, 21 N.E.2d 887, 1939; Note, 1939, 25 Corn. L.Q. 124.

N.E. 1090, 12 L.R.A.,N.S., 969, 9 Ann.Cas. 738; Waters v. Horace Waters & Co., supra. Before making such use it is not obligated to give to existing stockholders an opportunity to purchase. It is only when the capital stock is increased by the issue of new shares that each holder of the original stock has a right to subscribe for and demand from the corporation such a proportion of the new stock as the number of shares already owned by him bears to the whole number of shares before the increase. In that case the rule simply applies when the new stock is issued for money only, and not to purchase property necessary for the purposes of the corporation, or to effect a consolidation. Stokes v. Continental Trust Co., supra; Waters v. Horace Waters & Co., supra.

The order appealed from, therefore, is reversed, with ten dollars costs and disbursements, and the motion to punish appellants for contempt denied, with ten dollars costs. [68]

ROSS TRANSPORT, INCORPORATED, et al. v. CROTHERS et al.

Court of Appeals of Maryland, 1946. 45 A.2d 267.

Stockholders' derivative suit by Charles T. Crothers, for himself and for other stockholders who might join and be made parties, against Ross Transport, Inc., and Wallace Williams and others to set aside the issuance of shares of stock to defendants, Elizabeth B. Williams, Corrine Williams, Lois Williams Young, and William B. Ross, wherein Edmund W. Crothers joined as a party plaintiff. Decree for plaintiffs, and defendants appeal.

Affirmed.

MARBURY, CHIEF JUDGE. * * * It appears from the record that the corporation was organized on January 19, 1942 to operate a fleet of buses to transport employees of Triumph Explosives, Inc. to and from its plant at Elkton, Maryland. The incorporators were Wallace Williams, William B. Ross and Gervase R. Sinclair who later died. These three and F. DuPont Thomson and James W. Hughes were the directors. At the organization meeting of the directors, Williams was named as President and Ross as General Manager. The authorized stock was 5000 shares of no par value. At the organization meeting a resolution was passed authorizing the sale of this stock at $20 a share, and providing that stock to the value of $30,000 be offered for sale. This limited the stock to be issued to 1500 shares. * * * [The total original amount of stock issued was 1035 shares].

In the latter part of July 1942, after the death of Mr. Sinclair, Charles T. Crothers purchased the Sinclair stock, 200 shares, at $20 and 5% interest from the date of issuance. This did not, of course, increase the amount of stock outstanding. On August 26, 1942, the stock complained of was issued to the wife and daughters of Wallace Williams and to William B. Ross, totaling 365 shares in all, and increasing the outstanding stock to 1400 shares. All of this stock was

[68] See Sec. 39–4(d) N. Y. Stock Corp. Law, supra, p. 333.

issued at the set price of $20.00 a share. The stock issued to the Williams family was paid by Mr. Williams' check for $4800. Mr. Ross paid the company $2500 for his stock. * * *

Williams and Ross, therefore, had the controlling interest in the company. Mr. Williams testified that all of the stock in the company was sold by him personally under the directors' resolution. * * *

The sale of this additional stock to a director and to the family of the president and director without any further authority than the original resolution, and without opportunity to buy given to other stockholders, is sought to be justified on the ground that it was originally planned, and that the money was needed to purchase additional buses at a cost of about $16,000. The facts, however, show no such need. The company was an immediate financial success. It was engaged in a special business, of which it had a monopoly, and in which it could not help making money so long as Triumph Explosives continued to operate its large plant, employing the workmen the Transport Corporation hauled. * * * On November 27, 1942, a dividend of $5 a share was declared. On December 17, 1942 one of $15 (called a return of capital, but not authorized by the stockholders, Code, Article 23, Sec. 32). On the same date, another dividend of $5 a share was declared payable June 30, 1943. The defendants, Williams and Ross, who were operating the company, knew on August 26, 1942, that they were about to receive large sums in dividends in addition to the salaries they were getting. The benefit of these dividends would not only increase the value of the stock, but the first two would pay back all the subscribers had invested, leaving any future earnings and distributions pure profit. Under these circumstances, they took the opportunity they thought they had to increase their investment, and in fact received in December the full amount they invested in August, leaving them with the additional stock on which to receive such further dividends as were obviously in sight.

The appellants contend that the company was not in the claimed good financial condition in August, because no allowance had been made for income and profits taxes. But if we reduce the book surplus of $25,000 on August 16, 1942, by allowing for a 40% tax (the limit unless the earnings increased), we still find the company with a net surplus of $15,000, 75% of the original investment. The stock had no "market value," but it must be obvious that it was worth much more than $20 a share on August 26th.

The appellees give two reasons for their contention that the stock sales of August 26th were void: First because they deprive them and the other original stockholders of their pre-emptive rights to purchase a proportionate amount of the remaining shares, and, second, because, in selling to themselves and their nominees, Williams and Ross have abused their trust as officers and directors. They claim to be injured in two ways. Their voting powers have been proportionately lessened, and the control of the company has passed to Williams and Ross. And the amount paid in dividends has

to be divided among 365 more shares of stock to the consequent financial loss of the holders of the original shares. * * * The doctrine known as the pre-emptive right of shareholders is a judicial interpretation of general principles of corporation law. Existing stockholders are the owners of the business, and are entitled to have that ownership continued in the same proportion. Therefore, when additional stock is issued, those already having shares, are held to have the first right to buy the new stock in proportion to their holdings. This doctrine was first promulgated in 1807 in the case of Gray v. Portland Bank, 3 Mass. 364, 3 Am.Dec. 156. At that time, corporations were small and closely held, much like the one before us in this case. But in the succeeding years, corporations grew and expanded. New capital was frequently required. New properties had to be acquired for which it was desirable to issue stock. Companies merged, and new stock in the consolidation was issued. Stock was issued for services. Different kinds of stock were authorized—preferred without voting power but with prior dividend rights—preferred with the right to convert into common—several classes of both common and preferred with different rights. Some stock had voting rights. Other stock did not. Bonds were issued, convertible into stock. All of these changes in the corporate structure made it impossible always to follow the simple doctrines earlier decided. Exceptions grew, and were noted in the decisions.

Only one of these exceptions is involved in the present case. It has been held that pre-emptive rights do not exist where the stock about to be issued is part of the original issue. This exception is based upon the fact that the original subscribers took their stock on the implied understanding that the incorporators could complete the sale of the remaining stock to obtain the capital thought necessary to start the business. But this gives rise to an exception to the exception, where conditions have changed since the original issue. The stock sold the Williams family and Ross was part of the original issue, and it is claimed by the appellants that it comes within the exception, and the appellees and the other stockholders have no pre-emptive rights. Balto. Ry. Co. v. Hambleton, 77 Md. 341, 26 A. 279; Real Estate Trust Co. v. Bird, 90 Md. 229, 44 A. 1048; Thom v. Baltimore Trust Co., 158 Md. 352, 148 A. 234; Yasik v. Wachtel, Del. Ch., 17 A.2d 309; 40 Mich.L.Rev. 115. The appellees, on the other hand, contend, and the chancellors found, that changed conditions made it unnecessary to use the remaining unsold stock to obtain capital, and pre-emptive rights exist in it just as they would exist in newly authorized stock. Hammer v. Werner, 239 App.Div. 38, 265 N.Y.S. 172, Dunlay v. Avenue etc. Co., 253 N.Y. 274, 170 N.E. 917, 43 Harvard L.Rev. 586, 602–603.

It is unnecessary for us to decide which of these two conflicting points of view applies to this case, because another controlling consideration enters. The doctrine of pre-emptive right is not affected by the identity of the purchasers of the issued stock. What it is concerned with is who did not get it. But when officers and directors sell to themselves, and thereby gain an advantage, both in value and in voting

power, another situation arises, which it does not require the assertion of a pre-emptive right to deal with. * * *[69]

Decree affirmed with costs.

NOTE

In one instance, the Atlantic Refining Company effected a merger with its wholly owned subsidiary (the Point Breeze Manufacturing Company) for the purpose of eliminating preemptive rights of the common stockholders:

"The Common Stock will be unchanged, except as it is affected by the reclassification of the Preferred Stock, and except that after the merger the Common Stockholders will have no preemptive subscription rights. The offering of future issues of Preferred or Common Stock for subscription will thereafter be discretionary with the Board of Directors. The elimination of subscription rights will greatly facilitate financing because the hazards of an underwriting commitment over a subscription period result in less favorable prices to the Company and heavier underwriting charges. In periods of uncertain business and market conditions, the cost of such an underwriting may be prohibitive." [70]

Students of the subject will observe that the common stockholder's defense against "dilution" is sacrificed, without ceremony, to the alleged business convenience of financing.

4. CONSIDERATION RECEIVED FOR STOCK

NEW YORK STOCK CORPORATION LAW

§ 69. *Consideration for issue of stock and bonds.* No corporation shall issue either shares of stock or bonds, except for money, labor done or property actually received for the use and lawful purposes of such corporation. No shares of stock having par value shall be issued for money in an amount less than the par value of such shares. Any corporation may purchase any property authorized by its certificate of incorporation, or necessary for the use and lawful purposes of such corporation, and may issue stock to the amount of the value thereof in payment therefor, and the stock so issued shall be full paid stock and not liable to any further call, neither shall the holder thereof be liable for any further payment under any of the provisions of this chapter; and in the absence of fraud in the transaction the judgment of the directors as to the value of the property purchased shall be conclusive; and in all statements and reports of the corporation by law required to be published or filed, this stock shall not be stated or reported as being issued for cash paid to the corporation, but shall be reported as issued for property purchased.

§ 74. *Partly paid stock.* The certificate of incorporation or other certificate filed pursuant to law may contain a provision expressly authorizing the issue of the whole or of any part of the shares as partly paid, subject to calls thereon until the whole thereof shall have been paid in. The corporation may declare and may pay dividends upon the basis of the amount actually paid upon the respective shares. If upon

[69] That part of the opinion dealing with the directors' fiduciary duty appears, *infra*, p. 1051.

[70] The Atlantic Refining Company Proxy Statement, March 20, 1947.

the certificate issued to represent such stock the amount paid thereon shall be specified, the holder thereof shall not be subject to any liability to the corporation except for the payment of the amount shown by such certificate as unpaid.

DELAWARE GENERAL CORPORATION LAW

Sec. 14. *Issuance of Stock for Cash, Labor Done, or Real or Personal Property; Consideration for Shares of Stock Without Par Value; Determination of Amount of Capital; Statements of Amount of Par Value and of Amounts of Authorized or Issued Shares of Stock; Issuance of Partly Paid Shares, and Liability in Respect Thereof; Options in Respect of Shares:*—Subscriptions to, or the purchase price of, the capital stock of any corporation organized or to be organized under any law of this State may be paid for, wholly or partly, by cash, by labor done, by personal property, or by real property or leases thereof; and the stock so issued shall be declared and taken to be full paid stock and not liable to any further call, nor shall the holder thereof be liable for any further payments under the provisions of this Chapter. And in the absence of actual fraud in the transaction, the judgment of the directors, as to the value of such labor, property, real estate or leases thereof, shall be conclusive.

(a) Quality: Requirement That Consideration for Stock Issue shall be of a Stated Kind.

SCULLY et al. v. AUTOMOBILE FINANCE CO. et al.

Court of Chancery of Delaware, 1920. 12 Del.Ch. 174, 109 A. 49.

[The complainants are stockholders and directors of the Automobile Finance Co. and filed this bill to have cancelled all the common stock of the company. By amendment to the bill, all the common stockholders of the company were made defendants.

Two defendants, McEvilla and Chisholm, planned to establish an automobile agency to sell cars on the installment plan. They organized the Automobile Finance Company, under the laws of Delaware with dummy directors. 40,000 shares of capital stock of $10 par value were authorized, divided in 20,000 voting common and 20,000 nonvoting preferred.

As part of the plan, the same incorporators organized the Central Security Co., with a capital of 100 $50 par shares.

At the first directors' meeting of defendant company, McEvilla and Chisholm offered their scheme for the operation of the finance company and agreed to manage the corporation in return for 20,000 full-paid, non-assessable par value common shares. Said shares to be issued 19,988 to the Central Security Co. and three shares to each of four promoters. This offer was accepted by the dummy directors. A resolution valuing the plan and services so offered at $200,000 was adopted; the shares issued.

Later, defendant corporation engaged the services of the Central Security Co. as the exclusive selling agent for the preferred stock, on a commission basis. These shares were sold with a bonus of common stock. An additional bonus of common stock was given to directors of defendant company.]

THE CHANCELLOR. This suit was brought by four stockholders of the Automobile Finance Company to have cancelled all the shares of common stock of the company, on the ground that they had been issued without consideration and illegally. A demurrer to the original bill was overruled, answers were filed thereafter, and later an amended bill was filed and answers thereto filed. Testimony was taken, and a final hearing has been had. * * *

All of the shares of the common stock of the Automobile Finance Company of par value of two hundred thousand dollars were issued pursuant to the agreement made by the company with McEvilla and Chisholm, whereby they were (1) to turn over and assign to the company a plan of doing business, and (2) devote themselves to effectuating that business. Part of the consideration, therefore, was property and the rest consisted of services to be rendered. Did either constitute a valid consideration within the meaning of the constitution and statutes [71] of Delaware? The plan of business was an application to automobiles of plans by which prospective purchasers of property are assisted to buy and pay for the same and acquire title thereto, the company making the purchase and holding title until the whole of the purchase money is paid, in installments or otherwise, the customer in the meantime having possession under a form of bailment or lease. It was substantially the same as the Morris plan of banking. It was without novelty, had no element of property, was not assignable and could not in any fair sense be "acquired" by the company. Neither was it labor done, nor services rendered. It did not, therefore, constitute a valid consideration. This is equally true of the other thing which was stated as a consideration, the services to be rendered by McEvilla and Chisholm to the company. Services to be rendered cannot be a valid consideration for the issuance of full paid, non-assessable shares of stock, for these can be issued only for "labor done", i. e., after it has been done. This does not mean that shares may not be issued for services to be rendered so long as they are not marked fully paid until that condition has been fulfilled by rendering the service. By the statute shares may be issued before paid for, and will be subject to assessment either by the corporation or for the benefit of creditors up to the par value thereof, and this statute is not necessarily inconsistent with the constitution. General Corporation Law, Revised Code 1915, c. 65, §§ 20–23, pp. 925, 926.[72] Therefore, the issue in this case

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71 See, *supra*, p. 356 and *infra* f. n. 75, p. 362.

72 Del.Rev.Code 1915, c. 65, § 20: "When the whole capital stock of a corporation shall not have been paid in, and the assets shall be insufficient to satisfy the claims of its creditors, each stockholder shall be bound to pay on each share held by him the sum necessary to complete the amount of the par value of such share * * *, or such proportion of that sum as shall be required to satisfy the debts of the company * * *"

of the shares of common stock as full paid and non-assessable was without lawful consideration.

The pretense of a valuation by the directors of the consideration was ineffective to validate the consideration. Although there were two things offered as a consideration, the business plan and future services, the directors after accepting the proposition of McEvilla and Chisholm adjudged that "said service and effort on behalf of the corporation is of the actual value of two hundred thousand dollars to this corporation," and did not include the business plan in the valuation. There was no valuation of the plan of business, and the directors had no power to adjudge value to future services as a basis for full paid stock. Indeed, by their subsequent conduct the parties to that subscription agreement in effect concede that there was no lawful consideration for the common stock, for the corporation has so declared and levied an assessment thereon, and McEvilla and Chisholm have paid their assessments. This is probably not conclusive on other stockholders, and the complainants do not admit that the action of the company in making the assessment was valid.

But even assuming, as was contended, that the common stock was issued in part for labor done and to be done for the corporation, the business plan being a fruit of the labor performed, there was a conscious gross over-valuation thereof by the directors. Testimony was offered to show the services performed by McEvilla and Chisholm before the incorporation in framing the business plan, and of Chisholm since the incorporation, and there was testimony that the services of Chisholm were worth five thousand dollars, but no valuation was made of those of McEvilla. Obviously, then, there was an over-valuation of at least ninety-seven and one-half per cent., when something worth not more than five thousand dollars was valued at two hundred thousand dollars.

The legal effect of this conscious over-valuation has not been distinctly declared in this state where the corporation was a solvent, going concern. In Ellis v. Penn Beef Co., 9 Del.Ch. 213, 80 A. 666, the contract of subscription was valid, and there was no evidence of an over-valuation of the consideration for the shares of stock. There the question arose between a stockholder who had paid full value for his shares and other stockholders who had failed to deliver any but an insignificant part of the consideration for the stock. The Chancellor expressed the view that no pretended exercise of judgment could give value to that which had none. * * *

Under the circumstances of this case, what is the appropriate form of relief? All of the holders of common and preferred stock are parties to the cause. A prime consideration is that all of the holders of common stock took their shares with notice that they were bonus or gratuity shares, for which they paid or gave nothing (except perhaps Chisholm), or else they were put on inquiry, as were the shareholders held to be in Cooney Co. v. Arlington Hotel

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Sections 21–23 deal with subscriptions to capital stock; failure to pay for stock and remedies therefore; and certificate of payment of capital stock.

Cf. Del.Rev.Code 1935, §§ 20–23, and N.Y.Stock Corporation Law, §§ 67, 68, 70–73.

Co., 11 Del.Ch. 286, 101 A. 879, supra. Indeed, it is admitted by solicitors for all the parties who have appeared that the holders of common stock are in pari delicto, and the Automobile Finance Company has assumed that the stock is not full paid, but is assessable. It is also true that even the shares for which the incorporators subscribed have lost their identity as such.

The most equitable and appropriate relief in this case is to leave the parties as they find themselves; hold the shares of common stock assessable by the corporation for the purposes of the company; and in order to protect the holders of the common stock and also any transferees and the public, require that each share shall be made to show what has been paid or credited thereon, and that they are not full paid. The relief advocated by the solicitor for the complainants is that all of the common stock be declared to be void, and that a receiver be appointed to sell the common stock under the direction of this Court. It was not made clear who would issue the shares, and how the new regime could be inaugurated, and the plan does not seem fair, practicable or effective.

It is urged against this that the control of the company is left in the hands of those who have acquired many shares of common stock gratuitously, and it does appear that seven persons, holders of two thousand and eighty-seven shares of common stock out of the four thousand nine hundred and seventy-one and one-half shares outstanding, hold no preferred stock, and (except perhaps Chisholm) have given nothing to the company; and it also appears that other persons hold common stock as gratuities, though not received as a bonus with their preferred stock. But there is neither allegation nor proof of mismanagement, or collusive attempt to use control of the company for any improper purpose, or to the detriment of the shareholders. This last objection does not seem, therefore, to have weight.

Is Chisholm entitled to compensation for services rendered by him, and if so, how much and how will it be allowed to him? Under ordinary circumstances where there has been either a lack of a real valuation, or a conscious and perhaps gross overvaluation, and yet some value or consideration was given for shares of stock, a court of equity to do full justice may, where it is possible to do so, give the holder of the stock credit in some way for what is found by it to have been given as a consideration for the stock. In Ellis v. Penn Beef Co., 9 Del.Ch. 213, 220, 80 A. 666, it was intimated that this might be done, though in that case there was no opportunity to do so. This view is supported by the case of Vineland Grape Juice Co. v. Chandler, 80 N.J.Eq. 437, 85 A. 213, Ann.Cas.1914A, 679.

It would seem that Chisholm could be most fittingly compensated for his services by allowing him as a payment on the shares held by him such sum as his services to the company were worth. This would be paying him in the way he expected to be paid, viz.: in shares of common stock and not money. From the testimony submitted it is clear that his services were not worth five thousand dollars to the company, and that a credit of five per cent. on each of the fourteen hundred and ninety-seven shares of common stock held by him would

be a fair allowance therefor. This sum so allowed would be endorsed as payment pro rata on the shares of common stock of the company held by him, or otherwise as may be provided in the decree.

Inasmuch as the complainants as stockholders have by this suit been instrumental in putting on a legal basis the holdings of the common stock to the advantage of all of the stockholders of the Automobile Finance Company, the costs should be paid by that corporation.

Let a decree be entered accordingly. * * * [73]

NOTE

"The conclusion (drawn) * * * from * * * (the) review of the several 'good faith' rules as opposed to one another and to the 'true value' rule is that the distinctions are largely verbal. * * * There is little or no ground for making a practical distinction between the operation of the several rules, because the question in any case * * * resolves itself into a query as to what was a *reasonable* valuation of the property as made by the directors in the exercise of ordinary business judgment based on the circumstances that were evident at the time. * * * If the directors have exercised ordinary business prudence, and have valued the property as though they were purchasing it for their own use, the judgment will ordinarily be in favor of the defendant regardless of the nominal rule to which the court happens to subscribe. If, on the other hand, they made no serious attempt to value the property; or if they ignored the plain and obvious facts of the situation * * * the judgment will go against them. In effect, the standard of conduct for which all of the courts hold directors and shareholders responsible is that of ordinary business prudence. * * *" Reprinted from Dodd, "Stock Watering; The Judicial Valuation of Property for Stock Issue Purposes," by permission of Columbia University Press, 1930, 92–93.

JOHN W. COONEY CO. v. ARLINGTON HOTEL CO.

Court of Chancery of Delaware, 1917. 11 Del.Ch. 286, 101 A. 879.

[Defendant company was created under the laws of Delaware in 1911. Its authorized capital was fixed at $5,500,000, consisting of 55,000 shares of $100 par value each,—25,000 preferred and 30,000 non-assessable, full-paid common stock.

At the first meeting of the directors, the following resolution was adopted: "Resolved, that as the success of the enterprise will depend largely upon the energy, ability, and integrity of George Howard, Frank M. Andrews and James F. J. Archibald, in securing options on the property, promoting, financing and managing the same, and inasmuch as it is desired to offer additional inducements to subscribers of the preferred stock and to remunerate the said Howard, Andrews and Archibald for services rendered and to be rendered by them, and by others, therefore it shall be, and hereby is, assigned and transferred

[73] For a discussion of the issuance of stock for services or labor, see Dodd, Stock Watering, The Judicial Valuation of Property for Stock-Issue Purposes, 1930, c. III. See, also, McQuillen v. National Cash Register Co., 27 F.Supp. 639, D.C.Md., 1939, aff'd, 112 F.2d 877, C.C.A.Md., 1940, cert. den. 311 U.S. 695, 61 S.Ct. 140 (1940); rehearing den. 311 U.S. 729, 61 S.Ct. 316 (1940).

On stockholders' liability to corporate creditors for unpaid subscriptions of stock issued for overvalued property and services, see Holcombe v. Trenton White City Co., 80 N.J.Eq., 122, 82 A. 618, 1912.

to the aforesaid persons the entire issue of the common stock, to be used by them for the purposes named, with the distinct understanding that the holders of the common stock shall agree to transfer the same to a voting trust consisting of the aforesaid persons, and to receive in lieu thereof trustee certificates, for the purpose of vesting in them the right to vote thereon for a period of five years from the date of the incorporation, such voting trust being created for the purpose of carrying out the purposes aforesaid and the articles of incorporation uninterruptedly during that period."

The preferred shares were subscribed and the common stock was issued. Howard and Andrews (directors), pursuant to the plan of distributing common stock to subscribers to preferred stock, declared a voting trust of 19,800 shares of non-assessable, full paid common stock held in their names as trustees. They issued voting trust certificates for 3,747½ shares. The remaining 16,052½ shares, for which voting trust certificates were not issued, became the property of Howard and Andrews, as holders of common stock.

In 1914, the enterprise failed and receivers were appointed by the court. This bill was filed by the receivers in order to compel defendant's stockholders to pay fully for their stock; the money so paid to be used to satisfy unpaid corporate creditors.]

THE CHANCELLOR. * * * Inasmuch as there is a question common to all the holders of shares of common stock, whether holders of certificates of stock or of certificates of the voting trust, that question should be determined in this present proceeding. The question is, Was the total issue of common stock rightly issued as full paid and nonassessable stock so as to exempt all of it, however held, from assessment for creditors? "Work done" is an equivalent for money, and in the absence of actual fraud the judgment of the directors as to the value of such labor is conclusive. See section 14 of the act.[74] None of the common stock was paid for in money, and it is not so claimed by any holder thereof. But it is claimed that they were issued for services, or rather that they were paid for by services rendered and to be rendered, and as there is no proof as to the value of the services which were rendered, the stock must be treated as full paid, as it was stated to be on its face when issued by the company. It may be true, as between the corporation and a stockholder, that shares may be issued for services to be performed, though even that is doubtful. Vineland, etc., Co. v. Chandler, 80 N.J.Eq. 437, 85 A. 213, Ann.Cas.1914A, 679; Vogeler v. Punch, 205 Mo. 558, 103 S.W. 1001; Shannon v. Stevenson, 173 Pa. 417, 34 A. 218. Contra, Stevens v. Episcopal, etc., Co., 140 App.Div.

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[74] Del.Rev.Code 1915, c. 65, § 14: "*Issuance of Stock for Labor or Real or Personal Property:*—Subscriptions to or purchase of the capital stock of any corporation organized or to be organized under any law of this State may be paid for wholly or partly, by cash, by labor done, by personal property or by real property or leases thereof; and the stock so issued shall be declared and taken to be full paid stock and not liable to any further call, nor shall the holder thereof be liable for any further payments under the provisions of this Chapter. And in the absence of actual fraud in the transaction, the judgment of the Directors, as to the value of such labor, property, real estate or leases, shall be conclusive."
Cf. Del.Rev.Code 1935, § 14.

570, 125 N.Y.S. 573. "Work done" does not include promotion services performed before incorporation. Herbert v. Duryea, 34 App.Div. 478, 54 N.Y.S. 311, affirmed 164 N.Y. 596, 58 N.E. 1088. But when the interests of creditors are affected "work done" should not include prospective labor as an equivalent for money in exchange for shares of stock. By a strict construction "work done" does not include work to be done, or work done and to be done.

Whether it be moral, legal or actual fraud, or not fraudulent at all, the obvious purpose in issuing all the common stock to Howard, Andrews and Archibald, as set forth in the resolution of the directors at their first meeting on February 27, 1911, was to give them the stock without their having given the legal equivalent therefor. The most that could be claimed for it was that it was issued for services rendered and to be rendered, without stating what part of the $2,900,000.00 of common stock was issued for past services rendered and what for future services to be rendered. Furthermore the action as to the common stock was taken in the earliest stage of corporate life, viz.: at the first directors' meeting after the formal organization meeting, and at the first time when any business was done by the corporation, or any of its officers as such. When the incorporators met on January 28, 1911, for organization no business was transacted except to elect directors, and the issue of common stock was voted at the first meeting of directors on February 27, 1911, at which meeting officers were elected. With such scanty opportunity for having done work for the corporation after its organization, and in the absence of any statement of the character or value of such services theretofore rendered, or evidence of any valuation thereof by the directors, the issuing of $2,900,000.00 worth of stock for services rendered and to be rendered was of itself palpably indicative of an intention to avoid the statute and Constitution,[75] without reference to the other features of the resolution. In Ellis v. Penn Beef Co., 9 Del.Ch. 213, 80 A. 666, this court refused to regard as payment for stock the alleged delivery by the stockholders to the company of personal property when it appeared as a fact that though the property had been delivered it had not been paid for, but was in fact paid for by moneys of the company derived from other sources. It was a case of failure of consideration. In Holcombe v. Trenton, etc., Co., 80 N.J.Eq. 122, 82 A. 618, stock was issued in fact for services for promoters, and inasmuch as there was not of record any actual appraisement of the value of such services they were not regarded as payment in full, and the stock so issued was still subject to assessment for creditors as not full paid. But in fixing the liability of such stockholders, the court would have allowed them as credit on the par value of the stock the reasonable compensation for services rendered, if such proof had been made.

In the present case there was no valuation by the directors of the services of the promoters, and there has been no proof offered as to the

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[75] Del.Const. art. IX, § 3: "No corporation shall issue stock, except for money paid, labor done or personal property, or real estate or leases thereof actually acquired by such corporation."

This article remains unchanged.

value of the services which had been rendered by Howard, Andrews and Archibald at the time of the issue of the common stock to them, though opportunity to do so was open to the stockholders. It is readily seen that $3,000,000.00 of stock was such a gross and, therefore, unlawful overvaluation that counsel did not pretend that there was any appraisement by the directors, or if they had made such a valuation that any sensible person would have accepted their judgment. In the absence of such proof it is now open to this court to say that the directors have not determined that three million of stock was issued for work done, and that no value was given by the stockholders to the company for the common stock. Of course, it is obvious that the stock was to be bonus stock, issued without value. Therefore, it is impossible to escape the conclusion that the shares of common stock have not been paid for in whole or part. In the hands of the original takers, Howard, Archibald and Andrews, they were liable to assessment for creditors after the enterprise failed, and the corporation became insolvent. "Holders of bonus stock are always required to pay for their shares to satisfy the claims of creditors." Holcombe v. Trenton, etc., Co., 1912, 80 N.J.Eq. 122, 82 A. 618, affirmed without opinion in 82 N.J.Eq. 364, 91 A. 1069. An innocent purchaser for value who took these shares, would have been exempt from liability to pay any part of the par value thereof. * * *

Inasmuch as the question upon whom and in what proportions the assessment should be made, was not discussed by counsel, the court will, if it be desirable, hear counsel on the point before a decree is entered. * * *[76]

(b) Amount: Requirement That Consideration for Stock Issue shall be of Stated Value or Amount, and Determination Thereof

VALUATION OF PROPERTY CONTRIBUTED IN PAYMENT FOR STOCK

The various rules covering valuation of property transferred to a corporation as consideration for the issue of stock are exhaustively examined in "The Valuation of Property" by James C. Bonbright (Volume 2, Chapter XXIII, 1937). Professor Bonbright discusses the various statutes permitting stock to be issued in exchange for property of specified quantity up to the extent of the "value" of such property; but points out that this involves a judicial determination of "value". The Statutes commonly use colorless phrases such as "reasonable value", "actual value", "cash value", "fair valuation", "fair value" and so forth.

"Value" has many meanings: market value; or peculiar value to the corporation; or the price which would have been reached by arms length negotiation; or replacement value; or even "capitalized earning

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[76] Modified and affirmed, 11 Del.Ch. 430, 106 A. 39, 7 A.L.R. 955, 1918.

On the issue of stock for promoters' services, see, Note, Validity of Issuance of No Par Stock for Property and Services, 1930, 5 St.John's L.Rev. 95.

power", and so on. The word should always be looked at twice when it appears in any legal context. See also; David L. Dodd "Stock Watering —The Judicial Valuation of Property for Stock-Issue Purposes" (New York 1930).

New York Stock Corporation Law (section 69) provides: "no corporation shall issue either shares of stock or bonds, except for money, labor done or property actually received for the use and lawful purpose of such a corporation".

The following cases illustrate some of the conclusions reached by courts in wrestling with the problem of valuation of property used as consideration for the issue of stock.

BOYNTON et al. v. ANDREWS.

Court of Appeals of New York, 1875. 63 N.Y. 93.

[Appeal from judgment of General Term affirming a judgment for plaintiffs entered upon a verdict.

Creditors of the Empire Manufacturing & Planing Mill Co., a New York Corporation, brought this action under N.Y.Laws 1848, c. 40, § 10,[77] against defendant as a stockholder, to recover a debt due from the corporation on the ground that the capital stock was not full paid.

The certificate of incorporation stated that the company's authorized capital stock was $100,000, the whole amount being issued to purchase property from one of the trustees.

Testimony at the trial revealed that the property was worth at most, $50,000. The court charged that the amount of capital had not been paid in and directed a verdict for plaintiffs. Judgment was entered on the verdict; the judgment was affirmed by General Term; defendant appeals.]

MILLER, J. The second section of the act of 1853 (chap. 333), which amends the act authorizing the formation of corporations for manufacturing and other purposes (chap. 40, S.L.1848), confers authority upon the trustees of any such company to purchase property "necessary for their business and to issue stock to the amount of the value thereof in payment therefor."[78] The words "value thereof" evidently mean the fair valuation of the property, considering the purposes for which it is to be used, the nature of the business for which it is purchased and for the prosecution of which the corporation is organized. This rule authorizes an extended and wide latitude in the determination of the question of value. While certain kinds of property which are

[77] N.Y.Laws 1848, c. 40, § 10: "All the stockholders of every company incorporated under this act, shall be severally, individually liable to the creditors of the company in which they are stockholders, to an amount equal to the amount of stock held by them respectively for all debts and contracts made by such company, until the whole amount of the capital stock fixed and limited by such company shall have been paid in * * * and the capital stock so fixed and limited, shall all be paid in * * * within two years from the incorporation of said company or such corporation shall be dissolved."

Cf. N.Y.Stock Corporation Law, §§ 70 (*supra*, p. 315), and 73 (*supra*, p. 315).

[78] N.Y.Laws 1853, c. 333, § 2.

employed for manufacturing purposes, such as machinery, fixtures, etc., have a specific and definite value which is readily ascertained and fixed, there are other descriptions of property where the value is dependent upon circumstances which render it quite uncertain and frequently very difficult to decide what the real fair and just value of the same actually is. Mines and mining lands may properly be considered as embraced in the latter class, as their intrinsic value is fluctuating and uncertain and depends, to a very great degree, upon their successful development. It, therefore, may well be that an honest overvaluation might be made, of property of this kind, or agreed upon, without a semblance of intentional fraud. So, also, an error of judgment or a mistake in placing a valuation of property, appropriated as capital by a manufacturing company, if made in good faith and not to evade the provisions of the act in question, would not, of itself subject the owner of stock issued in payment of the property purchased to a personal liability. (See Schenck v. Andrews, 57 N.Y. 133, where the rule as to the valuation of such property is fully discussed.) A discrepancy in the opinions of witnesses upon the question of value cannot be considered as sufficient to establish fraud so as to render a stockholder individually liable. Nor can the value estimated and agreed upon by the parties, in all cases be regarded as the correct criterion by which to determine the actual and true value within the meaning of the statute, as such a rule might lead to the grossest abuse. As was held in the case cited, a discretion is vested in the trustees which calls for the honest exercise of their judgment. If they acted in good faith the stockholders could not be made liable. The real question in cases of this character is whether the property was placed and taken at a high valuation with a fraudulent intent of evading the provisions of the statute. While a disparity as to value might not establish fraud of itself, cases may arise where the acknowledged difference between the price allowed or agreed upon and the actual value is so erroneous as to bear upon its face clear and unmistakable indicia that a fraud was intended to be perpetrated. It cannot be questioned that where property, the value of which is well known and understood, or capable of being easily ascertained, is taken at a most exorbitant estimate, far beyond any intrinsic and real value, it raises a strong presumption that the valuation is not in good faith and was made for a fraudulent purpose. This presumption will be conclusive unless it is rebutted by evidence which fully explains the apparent bad faith. In the case at bar the whole amount of capital for which the stock was issued was $100,000. It is proved by the trustee from whom it was purchased that it was worth not to exceed $50,000, and it is thus established beyond any controversy that it was taken for double its real value. The articles taken were not of a class where the value was not apparent or depended upon circumstances, but such as any one familiar with that species of property could readily ascertain and estimate. In fact the trustee from whom they were purchased knew all about them as he had been the owner of the property, and the valuation he placed upon them is a conceded fact. There could be no mistake or error of judgment in fixing a value upon this particular property by its owner, and under the circumstances it is manifest that

there was a plain case of gross overvaluation with full knowledge of the facts. Such a transaction was fraudulent in law, on its face, and as the evidence stood there was no question of fact for the jury to pass upon. Had the case been submitted to the jury and they had rendered a verdict in favor of the defendant, it would have been the duty of the court to set it aside for want of evidence to sustain the finding. It follows that there was no error in the decision of the judge that the plaintiff had made out a case within the statute, and that the amount of the capital stock had not been paid in, as well as in his direction of the jury to render a verdict in favor of the plaintiffs.

The point made, that the holders of stock issued under the provisions of the act of 1853 are not and cannot be made personally liable for the debts of the corporation, whether such stock be full paid up stock or not, is without foundation. The act of 1848 (§ 10)[79] declares that the stockholders shall be individually liable to the creditors of the company to the amount of the stock, until the whole shall be paid in. The act of 1853, which was an amendment of the act of 1848, allowed trustees to issue stock for property purchased as therein provided, to the amount of the value of the same. The capital could be paid in property instead of money, and this did not change the effect of the act of 1848, which is applicable to cases where money is paid as well as to those where property is taken and the value thereof allowed. For the same reason a certificate is required to be filed in the one case precisely as in the other. Both stand on the same footing and are controlled by the same rule.

There was no error upon the trial in the rejection of evidence, and no other question raised which demands comment.

The judgment should be affirmed with costs.

NOTE

Many jurisdictions apply the "good-faith" rule, which exonerates stockholders from liability to creditors where the property has been valued in good faith. In this connection, consider what evidence can be adduced to prove "good faith". See, Colman and Finn, Comparison of Business Corporation Law of Minnesota and Delaware, 1938, 22 Min.L.Rev. 661, 667; Jennings and Solether, The Minnesota Business Corporation Act, 1937, 12 Wis.L.Rev. 419, 445–449; Wallstein, The Issue of Corporate Stock for Property Purchased—A New Phase, 1906, 15 Yale L.J. 111; Wickersham, The Capital of A Corporation, 1909, 22 Harv.L.Rev. 319, 322–329; Notes, 1924, 24 Col.L.Rev. 772, 1906, 19 Harv.L.Rev. 366, 1922, 31 Yale L.J. 883, 1928, 37 Yale L.J. 362; Book Note, 1903, 16 Harv.L.Rev. 382; 1913, 13 Col.L.Rev. 747; 1938, 22 Minn.L.Rev. 731.

STATE TRUST CO. v. TURNER.

Supreme Court of Iowa, 1900. 111 Iowa 664, 82 N.W. 1029, 53 L.R.A. 136.

[The Hess Electric Storage Battery Co. was organized in Iowa in 1890 to adapt and perfect certain patents. The authorized capital of the company was $100,000, of which not more than $90,000 might be

[79] Supra, f. n. 77, p. 364.

issued as fully paid to purchase necessary patents and property. The balance of the stock was to remain in the treasury, to be issued only upon payment of the face value thereof in cash.

The Board of Directors agreed to purchase certain patents for $90,000 full-paid capital stock and $500 cash from three of the incorporators. The contract recited that although the patents were worth only $500 at the time, they were believed to be of potentially great value.

The day before this contract was entered into, $1,000 in full-paid shares was issued to defendant, vice-president and a director of the corporation, who paid nothing for them. These shares were treated as part of the $90,000 to be issued.

The corporation experimented with the patents for several years without success. In 1893, it borrowed $670 from the Commercial Loan Association, who knew the above facts. The Association took the company's note for the loan and, at maturity, transferred it to plaintiff, who recovered a judgment which remained unsatisfied. This action is a suit on that judgment. The court below held for defendant; plaintiff appeals.]

DEEMER, J. (after reciting the facts). * * * Involved primarily is the so-called "trust-fund doctrine," as applied to stockholders' obligations to creditors. This is founded on the proposition that as the state undertakes to relieve the stockholder in a corporation of general liability for the debts of the concern, to the amount that he has invested in the enterprise, he ought, in good faith, to pay in money or its equivalent the face value of the stock received; and, if he fails to do this, he should be treated as holding the remainder in trust for the benefit of the creditors of the corporation. From this proposition two apparently conflicting and inconsistent rules have grown up, one of which may be called the "true-value rule," and the other the "good-faith rule." Courts adopting the good-faith rule are also divided on the proposition as to what is necessary to be shown to constitute good faith. Some of them hold that, in the absence of an affirmative showing of fraud aliunde, mere overvaluation of the property given in exchange for stock will not render the stockholder liable for the difference, while others hold that overvaluation itself, especially if gross, constitutes, or at least raises a strong presumption of, fraud. [Citing cases.] * * *

It will be noticed that there is some confusion in the New York and United States supreme court cases, and it is difficult to say just what rule prevails in Illinois. See Sprague v. Bank, 172 Ill. 149, 50 N.E. 19, 42 L.R.A. 606. But the supreme court has never departed from the principles of Sawyer v. Hoag, and other like cases. See Camden v. Stuart, 144 U.S. 104, 12 S.Ct. 585, 36 L.Ed. 363. Nothing further need be said regarding the attitude of the various courts of the country on these propositions. Some of the cases cited may not clearly fall to the places assigned them, but, on the whole, we think this as fair a classification of the authorities as can be made. In view of our previous holdings, this discussion may seem unnecessary; but, as counsel seem to think that the question is new to this court, we have attempted to state in brief some of the holdings in other jurisdictions.

We think our previous cases adopt the true-value rule,—perhaps not to its full extent; but such has been the drift of these cases. In Osgood v. King, 42 Iowa 478, we said: "Every principle of honesty and justice demands that, as between the stockholder and the creditor, the stock shall be considered paid only to the extent of the fair value of the property conveyed, and that for the balance the stockholder shall be held individually liable." In Jackson v. Traer, 64 Iowa 477, 20 N.W. 767, quoting from Taylor on Corporations, we said: "If the property secured is grossly unequal in value to the par value of the shares, the subscriber who secured the shares originally, or his subsequent transferee with notice of the circumstances, may be compelled to make up the difference in value." In Chisholm v. Forny, 65 Iowa 333, 21 N.W. 664, Seevers, J., speaking for the court, said: "Persons dealing with the corporation had the right to assume that it owned valuable assets to the amount of its capital stock; that is to say, that, in consideration for the stock issued, the corporation had received money or property which would be available to pay an indebtedness incurred in its business. A patent is, as has been said, a property in a notion, and has no corporal, tangible substance, and cannot be levied on and sold under execution issuing from state courts; and whether it can be sold on executions issuing from the federal courts is regarded as doubtful. Until its usefulness has been established, the value of a patent right is purely speculative." Judge Robinson, in Wishard v. Hansen, 99 Iowa 307, 68 N.W. 691, uses this language: "Where the capital stock of a corporation is issued to one of its promotors and organizers for property which is taken at a gross overvaluation, the transaction is fraudulent against creditors of the corporation, if it be insolvent; and the stockholder who receives such stock with knowledge * * * will be liable to creditors, on the stock he holds, for the difference between the par value * * * and the amount actually paid." In Stout v. Hubbell, 104 Iowa 499, 73 N.W. 1060, it is said: "It is alleged * * * that the land was given and received under an agreement that it was a full payment for the stock. This would, alone, be no defense; for this court has held, as to creditors of a corporation, that, when property is received by the corporation at an excessive valuation in payment for shares of its capital stock, it is only a payment to the extent of the value of the property received, and the owner of such stock is liable to creditors for the difference between the actual value of the property and the face value of the stock." In Carbon Co. v. Mills, 78 Iowa 465, 43 N.W. 290, 5 L.R.A. 649, we again quoted with approval the rule announced by Mr. Taylor in his work on Corporations, and said that no plea of fraud was necessary. From this review it is apparent that we have, in effect, adopted the true-value rule, although saying in some cases that the reason for so doing was to prevent fraud. There is nothing in these decisions or in the statutes that inhibits the taking of property in exchange for stock, providing it is taken at its true value; and this value we do not think should in all instances, if in any, be measured by results. The parties have the right in good faith to agree on the value of the property taken, but this should not be a speculative or fictitious one. An honest mistake in judgment will not necessarily destroy the

value agreed upon, but it must be such a valuation as prudent and sensible business men would approve. Values based on visionary or speculative hopes, unwarranted by existing conditions or facts, and without reasonable evidence from present appearances, are not such that the law will tolerate, as against creditors. It is apparent that the patent and property sold the corporation by Porter et al. had no such value as the parties placed upon it. The valuation was wholly speculative, visionary, and imaginary, as experience has shown. Indeed, we doubt if the parties thought it had any such value as they fixed upon it. They say they hoped and believed the company would realize therefor and thereon more than $90,000, but no one had the temerity to say that he regarded the patent and property as of that value. The actual value received was but little over $500. * * *

As the Commercial Loan Association had full knowledge of all the facts relating to the issuance and payment for the stock owned by the defendant, it could not recover. * * *

We have already said more, perhaps, than the case warrants; but as the questions are important, and the authorities are conflicting, we have attempted to lay down rules that may be followed in this class of actions, that are becoming more frequent in this age of corporations. Our conclusion is that the judgment of the trial court should be, and it is, affirmed.

NOTE

"[By the true-value rule] * * * payment for capital stock with property is no payment except to the extent of the true value of the property. If property is taken at an overvaluation the stockholder is liable to make up the deficiency and perform his obligation to give money or money's worth to the full amount of the par value of the stock taken." Ballantine, Stockholders' Liability in Minnesota, 1923, 7 Minn.L.Rev. 79, 93. See, also, Dodd, Stock Watering, 1930, c. III; Bark, Valuation of Property, Labor or Services Taken in Payment for Stock, 1919, 3 Marq.L.Rev. 195; Thompson, Payment of Shares in Property or Labor, 1893, 36 Cent.L.J. 92; Thompson, Payment for Shares in Property, 1902, 36 Am.L.Rev. 840; Warren, The Progress of the Law; Corporations, 1920, 34 Harv.L.Rev. 282, 285–288.

DONALD v. AMERICAN SMELTING & REFINING CO.

Court of Errors and Appeals of New Jersey, 1901.
62 N.J.Eq. 729, 48 A. 771, 1116.

DIXON, J. The bill in this case was presented by several holders of stock in the American Smelting & Refining Company to enjoin the company and its directors from entering into a contract with M. Guggenheim's Sons for (1) the transfer to the company of the smelting and refining plants, appurtenant property, and business of that firm; (2) the payment by the firm to the company, in cash or in working capital, of a sum equal to two-thirds of the company's working capital on January 1, 1901, said to be about $6,000,000; and (3) the payment by the firm to the company of the further sum of $6,066,666.66 in cash; and for the issuance and delivery to the firm by the company of $45,200,000 in aggregate par value of the company's capital stock, one-half thereof preferred and one-half common;—and also to enjoin

them from increasing the capital stock of the company from $65,000,000 to $100,000,000, in order to use the added $35,000,000, with $10,200,000 of its originally authorized capital stock, still held by the company, for the carrying out of such bargain.

On filing the bill and accompanying affidavits a rule to show cause and stay were granted by the chancellor, which, on the coming in of the answer and its accompanying affidavits, were discharged. [48 A. 786.] Thereupon the complainants appealed to this court, and, having secured from us a stay pending the appeal, brought on for hearing the application for an injunction pendente lite.

The controversy, in its present stage, turns upon the charge of the complainants, that the cash and property to be acquired by the company are not worth the par value of the stock to be issued therefor, and hence that the transaction contemplated is illegal.

The rule to be applied in determining whether on such a contention a contemplated original issue of corporate stock is legal or not, is prescribed by sections 48 and 49 of our Corporation Act, P.L.1896, p. 277.[80] They run as follows:

"Sec. 48. Nothing but money shall be considered as payment of any part of the capital stock of any corporation organized under this act, except as hereinafter provided in case of the purchase of property.

"Sec. 49. Any corporation formed under this act, may purchase mines, manufactories or other property necessary for its business, or the stock of any company or companies owning, mining, manufacturing or producing materials or other property necessary for its business, and issue stock to the amount of the value thereof in payment therefor."

The meaning of section 48 is not questionable. The money must equal the face value of the stock. The language of section 49 is even more explicit. The corporation may issue stock to the amount of the value of the property. The value of the property in the one case, just as the value of the money in the other, must at least equal the face value of the stock. Such was the view expressed for this court by Mr. Justice Depue in Wetherbee v. Baker, 35 N.J.Eq. 501, and supported by abundance of authority.

The distinction between the contemplated issue of corporate stock for property and its issues for money lies, not in the rule for valuation, but in the fact that different estimates may be formed of the value of

[80] *Cf.* N.J.S.A. 14:8-9: "Only cash or its equivalent and property, including stock of another corporation, and labor as in section 14:3-9 of this title is specified, shall be considered as payment of any part of the capital stock of any corporation organized under this title."

14:3-9: "Any corporation formed under any law of this state may purchase real and personal property and, * * * the stock of any other corporation necessary or desirable for its business, and pay therefor in cash or its equivalent, or in the capital stock of the purchasing corporation to the amount of the value thereof, and the stock so issued shall be fully paid stock and not liable to any further call. Any such corporation may also issue stock for the amount it actually pays for labor performed. When property or stock is purchased the purchasing corporation shall receive in property or stock what the same is reasonably worth in money at a fair bona fide valuation. No fictitious stock shall be issued."

Cf. N.Y.Stock Corporation Law, § 69, *supra*, p. 355.

property. When such differences are brought before judicial tribunals, the judgment of those who are by law intrusted with the power of issuing stock "to the amount of the value of the property," and on whom, therefore, is placed the first duty of valuing the property, must be accorded considerable weight. But it cannot be deemed conclusive when duly subjected to judicial scrutiny. Nor is it necessary that conscious overvaluation or any other form of fraudulent conduct on the part of these primary valuers should be shown, to justify judicial interposition. Their honest judgment, if reached without due examination into the elements of value, or if based in part upon an estimate of matters which really are not property, or if plainly warped by self-interest, may lead to a violation of this statutory rule, as surely as would corrupt motive. * * *

When corporate stock has once been issued for property purchased, then the legislature has directed the application of a different rule. In the words of the same section 49, "the stock so issued shall be full-paid stock, and not liable to any further call, neither shall the holder thereof be liable for any further payment under the provisions of this act; and in the absence of actual fraud in the transaction the judgment of the directors as to the value of the property purchased shall be conclusive."

Under these provisions, after the property has been purchased and the stock issued therefor, nothing short of actual fraud in the transaction can impair the right of the holder to hold his stock as full-paid stock, free from further call. The cases of Bickley v. Schlag, 46 N.J. Eq. 533, 20 A. 250, and Homestead Co. v. Wildes, 54 N.J.Eq. 668, 35 A. 896, indicate that the completed transaction was equally secure, even before the statute received its present decisive form.

By the rule above stated, then, the matter in hand must be judged. The evidence before us shows that, in the bargain projected, M. Guggenheim's Sons were to give, for $45,200,000 of stock, about $12,-000,000 in cash and working capital, their plants at Perth Amboy, N. J., at Pueblo, Colo., at Aguas Calientes and Monteroy, Mexico, and somewhere in South America, and their leases and contracts, the nature of which is not disclosed in these proceedings. Regarding the "cash and working capital" as so much money, and setting it off against an equal amount of stock, there remains about $33,000,000 of stock to be equivalenced by the property purchased. It is substantially admitted that the value of the plants themselves as physical possessions does not exceed $10,000,000 thus leaving about $23,000,000 to be made up in the value of the good will of the business and the leases and contracts mentioned.

The defendants insist that the complainants have not borne the burden cast upon them by law of proving that these items are not worth that sum, and certainly we would be unwilling now to adjudge that such a negative is established. But it must be remembered that the cause is yet in a preliminary stage; that the complainants have shown the value of everything which they could reasonably be expected to discover before instituting their suit; that the directors are their trustees, and are intending a very large issue of stock for prop-

erty which they have not seen fit hitherto to define. Under these circumstances, the legal rule imposing the burden of proof on the complainant should not be rigorously applied. Indeed, as these trustees are seeking to exercise a specially delegated power, which can be justly exercised only in accordance with a prescribed standard, it is not entirely clear that a burden does not rest on them, when challenged beforehand, to vindicate their proposed action. But, assuming the burden to be on the complainants, we think that for present purposes it is sustained.

The proofs point strongly to the conclusion that in the negotiations between the parties the real value of the property to be acquired has not been the basis on which they have determined the amount of stock to be issued therefor. This is explicitly stated in the affidavit annexed to the answer made by Daniel Guggenheim, who had entire charge of the negotiations on behalf of his firm. He said:

"From the outset the purpose of both parties was to reach a just conclusion as to comparative values, and to determine on that basis what amount of the securities we would justly receive for our business and properties, as against those of the American Company, represented by its outstanding $54,800,000 of stock."

In other words, on the assumption that the possessions of the company are worth $54,800,000, the parties concluded that what the firm was to deliver to the company is worth $45,200,000. This mode of arriving at the value of property to be purchased by the issue of stock is not that contemplated by the statute, and can be made to accord with it only by proof that the assumption is well founded. But there is no support for the assumption above stated, except the general averment that the company's net earnings for the year ending October 31, 1900, exceed $4,500,000 (i. e., about 8½ per cent. of the par value of its outstanding stock), and the fact that the shares of that stock are fully paid. The earnings of a single year hardly afford satisfactory evidence of the value of the company's property; and whether the shares are fully paid merely because they were issued for property purchased, without the presence of fraud in the transaction, and whether the consideration received for them has depreciated since the company was organized in April, 1899, we have not the means of knowing. What the defendants have taken care to show to the court, though for another purpose, is that the commercial world has never, until the proposed bargain came into view, estimated the stock of the company at more than two-thirds of its face value.

The fact just mentioned underlies another position taken by the defendants, viz. that the contemplated contract would be advantageous to the company and its stockholders, since even the mere expectation that it would be consummated has increased the value and market price of the stock, and therefore, it is argued, the complainants, as stockholders, are not aggrieved. But not there is the pith of the controversy. If the intrinsic value and market price of the company's stock were only 60 per cent. of its face, and an outsider were to offer 80 per cent. in money for additional stock to be issued, such an offer would clearly be advantageous to the company and its stockholders; but it

could not be legally accepted, because the legislature has required that 100 per cent., whether in cash or in property, shall be received for corporate stock when originally issued. It is the illegality of the transaction which warrants complaint. Stockholders have the same right to prevent an issue of stock in violation of the statute as they have to prevent a use of corporate property beyond the scope of the corporate power, without regard to loss or gain. Pom.Eq.Jur. §§ 1093–1095.

In view of the undefined nature of the property for which $23,000,000 of stock is to be issued, of the illegitimate basis on which the price to be paid for that property appears to have been fixed, and of the probability that the stock has been rated by the parties at its market value rather than at par, we think proper ground is shown for restraining the completion of the contract until full investigation can be made. * * *

For reversal—* * *9.

For affirmance—* * *5.[81]

DIAMOND STATE BREWERY, Incorporated v. DE LA RIGAUDIERE et al.

Court of Chancery of Delaware, 1941. 17 A.2d 313.

Suit by the Diamond State Brewery, Incorporated, against Camille De La Rigaudiere and others, for the cancellation of certain shares of complainant's capital stock owned by respondents.

Decree in conformity with opinion advised.

Suit for the cancellation of certain shares of complainant's capital stock owned by respondents. The original bill named Camille de la Rigaudiere, Guy de la Rigaudiere and Isabelle de la Rigaudiere Tunis as respondents, and the case was heard on the bill, answer of these parties, testimony, and exhibits. At the conclusion of the hearing, complainant obtained leave to amend and did amend its bill in order to join as a party respondent the Reverend Sylvester A. Hosinski. This respondent answered the amended bill; and before the argument of the cause, the solicitors for all parties agreed that it be finally determined upon the pleadings and the evidence theretofore adduced.

THE VICE CHANCELLOR. Complainant's case is that certain shares of its capital stock now owned by respondents were illegally issued without sufficient consideration and should therefore be cancelled. Respondents deny illegality in the original issuance, and assert that in any event, as to most of the shares, they were bona fide purchasers for value without notice of any infirmity, and that the stock should not be cancelled.

Complainant was incorporated under the laws of Delaware on April 7, 1933. Its name, New Jersey-Delaware Brewing Company, was later changed to Diamond State Brewery, Inc. On March 22, 1933, a short time prior to its organization, the Congress of the United States authorized the manufacture of beer with a limited alcoholic content. 48 Stat. 16. In Delaware, such manufacture was permitted by an Act

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81 Wickersham, The Capital of a Corporation, 1909, 22 Harv.L.Rev. 319, 322; Note, 1901, 1 Col.L.Rev. 402; 1901, 1 Col.L.Rev. 407.

of the General Assembly, passed on May 3, 1933. 38 Del.Laws, c. 19. The time of complainant's incorporation, its name, its objects and purposes as stated in its certificate of incorporation, as well as the activities it actually carried on, all indicate that the motivating purpose of its organization was the production of beer.

The incorporators named in complainant's certificate of incorporation were employees of a company which undertakes the work of preparing corporate charters and forming Delaware corporations and which acts as statutory agent for them. Neither the incorporators nor original directors, elected by the former, appear to have had any substantial financial interest in the corporation. One Guy de la Rigaudiere was the principal if not the sole promoter of the corporation, as is apparent from a resolution of the directors adopted at their first meeting, "That due appreciation be given to Guy de la Rigaudiere for his services as organizer of the New Jersey-Delaware Brewing Company which have extended over a period of eight months. * * *".

Complainant's charter authorizes the issuance of 800,000 shares of Class A Stock of the par value of one dollar, and 200,000 shares of Class B Stock of the par value of twenty-five cents per share, the latter Class being the voting stock. At the meeting of the incorporators, April 7, 1933, there was presented a written offer of Guy de la Rigaudiere, dated the same day, to sell and assign all his "rights, title and interest in and to a secret formula for the compounding of a beverage known as 'Chamonix' with all necessary equipment to manufacture the same and to accept in full payment therefor fifty thousand shares of your Class A stock and one hundred and twenty five thousand shares of your Class B capital stock full paid and non-assessable". The incorporators adopted a resolution authorizing the board of directors "to acquire said formula and equipment and to issue said stock in payment therefor, provided same are in the opinion of the Board of Directors of the actual value above stated and necessary to the business of the Company". The directors at their first meeting resolved that the company accept the offer in accordance with the resolution of the incorporators; and the board did "adjudge and declare that said formula and equipment are of the actual value of $81,250.00 and that same are necessary for the business of the company which is hereby authorized and directed to issue" the stock to de la Rigaudiere or his nominees "in full settlement for the above formula and equipment".

The value, $81,250, fixed by the directors, was equal to the par value of the shares authorized to be issued. All of such shares were issued as full paid to persons designated by Guy de la Rigaudiere; and 41,830 Class A shares and 117,155 Class B shares were registered in the names of Guy de la Rigaudiere and his wife, Camille de la Rigaudiere, one of the respondents. Most of these shares were so held at the death of Mr. de la Rigaudiere in February 1934. From them are derived the shares which complainant would now have cancelled in the hands of the respondents.

Complainant says that the issuance of this stock was without consideration and in violation of the following provisions of the Constitution of the State of Delaware, and of the Delaware Corporation Law:

[Quoting Art. IX, § 3 Del. Const. and Del. Gen. Corp. Law, § 14, *supra,* p. 356.] * * *

Complainant adduced evidence concerning the formula and equipment for which the directors agreed to issue the shares. In 1932 or 1933, one Marcel Tournier, a naturalized citizen of French birth, who resided in Vineland, New Jersey, sold to Mr. de la Rigaudiere a formula for Chamonix, and equipment, consisting of a saturator and a carbonator for manufacturing it. For these, de la Rigaudiere agreed that Tournier should receive, after the organization of the present complainant corporation, one thousand dollars in shares of its capital stock. Tournier transferred the formula but never delivered, and complainant never received the equipment. Tournier testified: "I didn't deliver the machine to him [de la Rigaudiere] because I sold him the equipment and formula for the sum of one thousand dollars in shares of stock, but I only received five hundred shares of Class A stock and fifty shares of Class B stock, which was around six hundred dollars, so there was around four hundred dollars due to me, and I didn't deliver the equipment."

Tournier further testified that he had bought the equipment in France; that the formula was regularly supplied with each purchase of equipment; that the formula was not secret but was known all over France; that it was valueless; that from 1922 to 1924, he, Tournier, had manufactured a beverage from the formula and that he had given it the name "Chamonix", but that he had stopped making it because he didn't know the English language, couldn't sell the drink, and "lost money on it". * * * An examination of the formula itself raises serious doubt whether it alone contains sufficient directions to enable anyone to make any certain beverage. It specifies a quantity of "coloring matter" but does not designate any particular color or coloring material. It specifies a quantity of "essence", presumably a flavoring component, but fails to prescribe the kind of essence. Complainant never undertook to do anything with the formula. The directors did not even take the trouble to acquire the equipment with which to make use of it. Certainly no justification is apparent for the great disparity between the price de la Rigaudiere agreed to pay Tournier, and the price at which he agreed to sell the same property to the corporation he had organized. The evidence, it seems to me, fairly establishes that the formula had no substantial value.

Respondents correctly assert that under Section 14 of the Delaware Corporation Law, in the absence of actual fraud in the transaction, the judgment of the directors as to the value of the property acquired shall be conclusive; and that consequently, a showing of no more than excessive valuation is insufficient to overcome the conclusiveness of the directors' judgment. But the attending circumstances may constitute a proper basis for a finding of fraud; and inadequacy of consideration may be considered in connection with other facts from which fraud may be inferred. McCombs Producing & Refining Co. v. Ogle, 200 Ky. 208, 254 S.W. 425. Here, in addition to gross overvaluation, a partial failure of consideration has been demonstrated. The equipment, never received, appears from the testimony of Tournier to be the only

part of the consideration which had value. The Delaware constitution contemplates the production of the thing itself and not the mere promise to produce, to justify the issuance of stock as full paid. Sohland v. Baker, 15 Del.Ch. 431, 141 A. 277, 58 A.L.R. 693. The issuance of stock as full paid for a consideration never delivered to, nor acquired by the corporation constitutes "actual fraud" within the meaning of Section 14 of the Delaware Corporation Law. Ellis v. Penn Beef Co. et al., 9 Del.Ch. 213, 80 A. 666. Indeed, the circumstances of this case point to the conclusion that the resolutions and dealings with respect to the formula and equipment were nothing more than a veil to hide the issuance of shares without consideration. There was thus a violation of the constitutional and statutory requirements. Sohland v. Baker, supra; Blair et al. v. F. H. Smith Co. et al., 18 Del.Ch. 150, 156 A. 207; Ellis v. Penn Beef Co. et al., supra.

All of the shares sought to be cancelled are a part of those originally issued in the joint names of Guy de la Rigaudiere and Camille de la Rigaudiere. Some of the respondents contend with respect to the shares claimed by them that they are bona fide purchasers for value without notice or knowledge of any infirmity; and that in consequence the corporation is estopped from denying the recital in the stock certificate that the shares are full paid and nonassessable. * * * Without regard to any questions as to the consideration for the transfer of the shares, the registered holders have not demonstrated that they were innocent purchasers. * * *

Lastly, respondents insist that the proper remedy is assessment of the unpaid purchase price of the shares rather than cancellation. The rule in Delaware has been stated in Blair et al. v. F. H. Smith Co. et al., 18 Del.Ch. 150, 165, 166, 156 A. 207, 213: If the issuance of stock was void, cancellation is the proper remedy; if merely voidable, "then that form of relief is to be adopted which would seem to be most in accord with all the equities of the case." I find nothing in the position of the respondents which would justify allowing them to retain the Class B stock in question. Complainant is entitled to relief; it has prayed for cancellation; no reason has been suggested why that form is inadequate from its standpoint. Thus, the prayer should be granted with respect to the B stock. The same may be said as to the A stock pledged with the bank, except that the bank's interests must not be prejudiced. When a form of decree is presented, the solicitors may suggest provisions appropriate to safeguard the rights of the bank and at the same time to afford relief as to any remaining interest in the shares.

A decree in conformity with this opinion will be advised.

COHEN (COHEN INTERVENER) v. BENEFICIAL INDUSTRIAL LOAN CORPORATION et al.

District Court of the United States, D. New Jersey, 1946. 69 F.Supp. 297.

Stockholders' derivative suit by Hannah Cohen, executrix of the estate of Sol Cohen, deceased, against the Beneficial Industrial Loan Corporation, a corporation, and others for appointment of a receiver and for an accounting for funds and assets that individual defendants were alleged to have fraudulently diverted and appropriated to their own use, wherein David F. Cohen intervened as a party plaintiff. On motions by the individual defendants for an order dismissing the fourth, fifth, sixth, seventh, and ninth causes of action and for a more definite statement or a bill of particulars, and on countermotion by plaintiff for leave to take depositions and for issuance of subpoenas duces tecum.

Defendants' motions to dismiss fifth, sixth, seventh, and ninth causes of action granted, and motion to dismiss fourth cause of action denied.

MEANEY, DISTRICT JUDGE. This action, a stockholder's derivative suit, was instituted by Sol Cohen in 1943, as the holder of 100 shares of Common Stock which had been acquired by purchase in 1937, and seeks the appointment of a receiver and an accounting for funds and assets which it is alleged the individual defendants fraudulently diverted and appropriated to their own use.

David F. Cohen, as holder of 150 shares of the corporation's common stock, intervened as a party plaintiff. On February 14, 1946, by order of the court, Hannah Cohen, executrix of the estate of Sol Cohen, deceased, was substituted as plaintiff. * * *

The fifth cause of action, against which the defendants likewise seek a dismissal, charges that at or after the time of incorporation of the defendant, Industrial, in May, 1929, it acquired the combined assets of the former Beneficial Industrial Loan Corporation, American Loan Company and Industrial Bankers of America, and at the same time assumed all the liabilities of the three aforementioned companies.

Prior to the acquisition of such assets, it is alleged that the former Beneficial Loan Corporation one of the acquired companies, was organized and had acquired assets of three other loan companies by the issuance of 1,250,000 shares of its capital stock. It is further charged that at the time of the issuance of those shares, the former Beneficial Industrial Loan Corporation wrote up the value of the assets transferred from the three companies from which they were acquired, by more than eight million dollars and that the defendant, Industrial, acquired this stock at the same value ascribed to it on the books of the former Beneficial Industrial Loan Corporation, even though an examination of the books of that company would have revealed the excessive value at which the assets were written up and held. It is then charged that the defendant, Industrial, upon acquiring the assets of the former Beneficial Loan Company, American Loan Company,

and Industrial Bankers of America in May 1929, issued its stock to the stockholders of these three companies, in exchange for the stock held by them respectively in said three companies, the stockholders of the former Beneficial Industrial Loan Corporation receiving stock from defendant, Industrial, on the basis of the inflated values previously ascribed to the stock of the former Beneficial Industrial Loan Corporation. Thereafter, it is charged, in September of 1930 the book value of the assets which had been acquired by the defendant corporation from the former Beneficial Industrial Loan Corporation was written down from its inflated value to the same extent as it allegedly was previously written up. As a result of the above it is charged that there was fraudulently and unlawfully issued, 449,209 shares of common stock of defendant corporation which remain outstanding and for which no consideration has been paid or received by it. Upon the shares so issued, it is further charged there has been unlawfully paid by the corporation, from 1929 to 1945, inclusive, more than eleven million dollars by way of unlawful and illegal dividends.

This alleged cause of action is objected to and dismissal sought on the ground that it fails to state a claim upon which relief can be granted in this action. Defendants insist that any possible cause of action which could be predicated upon the transactions asserted in the fifth alleged cause of action, would be on behalf of the individual stockholders of American Loan Company and Industrial Bankers of America, Inc. against the stockholders of the former Beneficial Industrial Loan Corporation. In any event it is insisted that the plaintiff fails to set forth any cause of action on behalf of the corporation since there is nothing contained in the charges that would indicate that any rights of the corporation have been invaded resulting in damage to it.

Examination of the allegations contained in the fifth alleged cause of action support the defendants' contention that the plaintiff has failed to show any damage to the corporate entity.

The stock issues referred to consisted entirely of shares of stock without par value. Under Delaware law, necessarily controlling insofar as the validity of the stock issue in question is concerned, (the defendant being incorporated under the laws of the State of Delaware) there is no requirement as to the amount of consideration which must be received in respect to an original issue of no par stock, although the quality of consideration must meet the same requirements as stocks having a par value. Bodell v. General Gas & Electric Corporation, 15 Del.Ch. 119, 132 A. 442, affirmed 15 Del.Ch. 420, 140 A. 264; West v. Sirian Lamp Co., Del.Ch., 37 A.2d 835.

Hence, where it is apparent that the original stock issue is of no par stock, the amount of consideration is of no particular moment in an action of this nature.

While it may well be that as a result of the manipulation alleged, an excessive valuation was placed upon the assets of one of the consolidating corporations, resulting in an improper proportionate distribution of the new stock, it cannot be concluded thereby that, the new stock being of no par value, no consideration has been paid for it. There has been no damage to the defendant corporation thereby, since the

only result, as far as the corporation is concerned, was that each share simply represented a proportionately smaller part of the total corporate assets. There is no way to spell out any increase in corporate liabilities and hence no damage to the corporation to which the plaintiff can point. * * *

It is further stated by the plaintiff that the defendant, Industrial, acquired the stock of the former Beneficial Industrial Loan Corporation at the value ascribed to it on the books of that corporation "even though an examination of the books of that Company would have revealed the excessive value at which its assets were written up and held." Any stockholder had the right to examine the books of the Company; but nevertheless, the Agreement of Consolidation, out of which the present corporate defendant grew, was approved by more than ⅔rds of the stockholders of each of the consolidating companies. This in effect, negatives any suggestion of fraud and misrepresentation.

Since a stockholder's derivative suit on behalf of the corporation derives its cause of action out of an invasion of the rights of the Corporation, if the Corporation itself has no such cause of action it necessarily follows that a stockholder cannot sue in its behalf. Gallagher v. Pacific American Co., 9 Cir., 97 F.2d 193; Laughner v. Schell, 3 Cir., 276 F. 241, 18 C.J.S., Corporations § 559. Under the facts set forth in the fifth alleged cause of action, defendant, Beneficial Industrial Loan Corporation, could not maintain this action, and plaintiff suing as a stockholder has no better right. Defendants' motion to dismiss the fifth cause of action, for the reasons above set forth, is granted. * * *

An order in accordance with the above ruling may be entered.

5. STOCK OPTIONS

DELAWARE GENERAL CORPORATION LAW

§ 14. * * * Subject to any provisions in respect thereof set forth in the Certificate of Incorporation every corporation shall have power to create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes, such right or options to be evidenced by or in such instrument or instruments as shall be approved by the Board of Directors. The terms upon which, the time or times, which may be limited or unlimited in duration, at or within which, and the price or prices at which any such shares may be purchased from the corporation upon the exercise of any such right or option shall be such as shall be fixed and stated in the Certificate of Incorporation or in any amendment thereto, or in a resolution or resolutions adopted by the Board of Directors providing for the creation and issue of such rights or options, and, in every case, set forth or incorporated by reference in the instrument or instruments evidencing such rights or options; provided, however, that, in case the shares of stock of the corporation to be issued upon the exer-

cise of such rights or options shall be shares having a par value, the price or prices so to be received therefor shall not be less than the par value thereof; and provided further, that in case the shares of stock so to be issued shall be shares of stock without par value the consideration therefor as to corporations incorporated prior to April 1, 1929, and on or after April 1, 1929, as the case may be, shall be determined in the manner hereinabove provided in this Section for the fixing of the consideration for the issue of such stock.

NOTES

OPTIONS TO PURCHASE STOCK

(A) The modern "warrant" or option to purchase stock in a limited or unlimited period of time has not, as yet, been litigated, and there is no law available on it, though the device was known as early as 1872, and formed a part of the financing of the Illinois Central Railroad.

Warrants are now apt to be used either

(a) To give to promoters, bankers, and others a chance to make profits out of the rise of the stock or securities in respect of which the warrant is issued; or

(b) To be attached to bonds or preferred stock as an additional inducement to their purchasers; or

(c) As a straight means of raising capital.[82]

The public utility companies have issued them in great volume; some having more warrants outstanding than they have stock.

Warrants tend to retard the advance of stock in the open market. They are normally not exercised when the corporation is in bad shape and needs capital, and they normally are exercised when the corporation is in good shape and could secure the capital far more cheaply, if it needs it at all.

They travel from hand to hand, much as different shares of stock; but there is no judicial decision as yet as to their negotiability.

It remains to be determined whether a warrant holder has any interest in the corporation which will be recognized by law. His financial interest, however, is sufficiently plain.

(B) "A stock purchase warrant may be defined as a corporate instrument by whose provisions the corporation binds itself to deliver shares of its stock to the holder at his election upon payment to it by the holder of a specified sum of money per share, at or within a time and on conditions set forth in the instrument. * * * Commonly they are delivered by the corporation at the time of the sale of its bonds or notes, as part consideration for the payment of the purchase price of such obligations * * * They are frequently delivered to banking houses of issue and retained by such houses as a part of their compensation for undertaking flotation of an issue of securities. * * * Their only invariable features are covenants on the part of the issuing corporation to deliver stock upon payment of a stated price * * * and covenants defining and limiting the time or times, or period of time, * * * at or within which the privilege may be exercised." Berle, Convertible Bonds and Stock Purchase Warrants, 1926, 36 Yale L.J. 649.

(C) "The warrant holder is in no sense a stock holder. His rights are based upon his contract, which is to deliver, upon exercise within a certain time by the payment of a stated amount, a certain amount of shares. The integrity of the shares must be maintained. In the case of a dissolution, the option holder is entitled to nothing and can not stand in the way of ending the business.[83] In the

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[82] Another common use of options to purchase stock appears, f. n. 85, *infra*.

[83] The fact that a corporation is in equity receivership at the time the owner of stock purchase warrants seeks to exercise his option to purchase treasury stock

case of mergers with another corporation, or consolidation or formations of a new corporation, there is a question of whether the corporate identity can be traced through the proceedings to determine whether the warrant holder will be able to enforce his option against stock of the new company. * * * As long as the corporation will deliver to him the shares denominated in his contract, or the equivalent capital value thereof, upon the payment of the option price, the option holder has no cause of action. * * * There is no breach of contract until refusal to deliver the shares and no cause of action arises until the election to exercise. The corporation has not the *power* to revoke the paid-for offer, or to destroy the power in the offeree to accept. * * * It is not beyond the power of the corporation still to deliver even after it has sold the shares that are reserved for the exercise of the warrant, although, if it sells out the shares * * * reserved for the exercise of the warrant, it may encounter problems of pre-emptive rights in a new issue." Garner and Forsythe, Stock Purchase Warrants and "Rights", 1931, 4 So.Calif.L.Rev. 375, 385–387.[84]

(D) "Legally, option warrants are subject to a number of serious objections which have not been worked out. The first is the chance that they may be held to be pure gambling contracts, not designed to represent any actual delivery of the stock. The second is that at the time when the stock purchase warrants are issued, particularly if they are perpetual, it is almost beyond human wisdom to set any fair price on such options. A board of directors issuing them (or bankers buying them) must necessarily fix a price determined solely by what the traffic will bear; and a stock holder who chooses to step in and enjoin the transaction on the ground that the price bore no relation to the ultimate participation, may very easily succeed in so doing.[85] In the third place, they share the weakness of convertible bonds. If, when the time comes, the corporation either has not the stock to deliver or does not wish to deliver it, the remedies of the shareholders are nothing if not obscure. Courts will probably not decree the issue of the stock. The amount of damages they would grant to the disappointed holder is as yet unascertained." Berle, Corporate Devices for Diluting Stock Participations, 1931, 31 Col.L.Rev. 1239, 1262–1263.

(E) "* * * of itself, a stock option warrant is not a negotiable instrument because the Negotiable Instruments Law requires that a promise to pay money must appear; * * * the qualities of a negotiable instrument may be secured by the insertion of a proper contract agreement in the option warrant itself * * *" Garner and Forsythe, Stock Purchase Warrants and "Rights", 1931, 4 So.Calif.L. Rev. 375, 391.[86]

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is no defense to the corporation in an action for breach of the option contract. North Butte Mining Company v. Tripp, 117 F.2d 304, C.C.A.Minn. 1941.

[84] On the power of a corporation to revoke its offer to stockholders to purchase stock as of a certain date, before that day arrives, see, Note, 1930, 39 Yale L.J. 1163.

[85] But see, McQuillen v. National Cash Register Co., 27 F.Supp. 639, 648–655, D. C.Md.1939, aff'd, 112 F.2d 877, C.C.A.Md.1940, where a corporate officer, in consideration of his being the general manager of defendant corporation, was given a five-year option to purchase stock, provided that the option would become null and void if he ceased to be either an officer or a director of the corporation. The contract was upheld, the court saying that its consideration was the promise to become chairman of the board of directors and of the executive committee of the company and to undertake the duties incident to those offices. Nor was this invalid as an issuance of stock for future services, because here, the court said, there was no *issuance* of stock, but the application of stock already issued and held in the corporate treasury. This was a contract for the future delivery of stock, if and when the particular services had been periodically rendered. Nor did the court sustain plaintiff's contention that this option was in effect, a gift, because the officer was receiving in addition a salary of $100,000 a year. The court refused to interfere with the judgment of the board of directors in fixing the compensation of this officer.

[86] See. also. on stock purchase warrants: Berle and Means, The Modern Cor-

C. DIVIDENDS

NOTE

1. DEFINITIONS

"A dividend is a corporate profit set aside, declared and ordered by the directors to be paid to the stockholders upon demand or at a fixed time, Cook Corp., 6th Ed., § 534." People ex rel. Pullman Co. v. Glynn, 1909, 130 App.Div. 332, 333, 114 N.Y.S. 460, order affirmed, 1910, 198 N.Y. 605, 92 N.E. 1097.

"That portion of the profits and surplus funds of the corporation which has been actually set apart by a valid resolution of the board of directors, or by the shareholders at a corporate meeting, for distribution among the shareholders according to their respective interests, in such a sense as to become segregated from the property by the corporation, and to become the property of the shareholders distributively. 2 Thomp. Corp. § 2126." Bouvier's Law Dictionary, title Dividend.[1]

PROBLEMS OF DIVIDENDS

Early corporations (for instance, the British East India Company) did not declare dividends in the modern sense. They carried out a voyage as an enterprise; liquidated it; and divided the entire assets of the corporation, capital as well as profits. At a later phase the business practice developed of keeping capital intact and declaring to the stockholders a fraction of the profits: dividends.

The right of a corporation to declare dividends depends on certain precedent conditions determined by statute. Commonly dividends must be declared out of "surplus"—assets in excess of the aggregate of existing debts plus statutory "capital". In some states, however, there is an exception to the rule: dividends may be declared out of "net profits arising from the operation of business"—and the statutory

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poration and Private Property, 1932, 151–152, 180–185, 199–202; Berle, Studies in the Law of Corporation Finance, 1928, c. 7; Doris and Friedman, Corporate Secretary's Manual and Guide, 1936, 726–732; Ballantine, Questions of Policy in Drafting a Modern Corporation Law, 1931, 19 Calif.L.Rev. 465, 468–469; Berle, Convertible Bonds and Stock Purchase Warrants, 1926, 36 Yale L.J. 649; Garner and Forsythe, Stock Purchase Warrants and "Rights", 1931, 4 So.Calif.L.Rev. 269, and 375; Hills, Model Corporation Act, 1935, 48 Harv.L.Rev. 1334, 1357, n. 34; Keith, Convertible Securities and Stock Purchase Warrants, 1929, 2 Rocky Mt. L.Rev. 16; Notes, 1929, 29 Col.L.Rev. 491, 1937, 37 Col.L.Rev. 785, 798–804, 974–976, 1939, 6 U. of Chi.L.Rev. 399, 435–437.

[1] For general discussion of the subject of dividends, see: II Bonbright, The Valuation of Property, 1937, c. 27; Hatfield, Accounting, 1932; Reiter, Profits, Dividends and the Law, 1926; Ballantine and Hills, Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws, 1935, 23 Calif.L.Rev. 229; Berle and Fisher, Elements of the Law of Business Accounting, 1932, 32 Col.L.Rev. 573; Frey, The Distribution of Corporate Dividends, 1941, 89 U. of Pa.L.Rev. 735; Greenough and Ayers, Funds Available for Corporate Dividends in Washington, 1934, 9 Wash.L.Rev. 63; Hills, Model Corporation Act, 1935, 48 Harv.L.Rev. 1334, 1364–1370; Katz, Accounting Problems in Corporate Distributions, 1941, 89 U. of Pa.L.Rev. 764; Kehl, The Origin and Early Development of American Dividend Law, 1939, 53 Harv.L.Rev. 36; Kripke, Accountants' Financial Statements and Fact Finding in the Law of Corporate Regulation, 1941, 50 Yale L.J. 1180; Sparger, Profits, Surplus and the Payment of Dividends, 1929, 8 N.C.L.Rev. 14; Weiner, Theory of Anglo American Dividend Law: The English Cases, 1928, 28 Col.L.Rev. 1046; Weiner, Theory of Anglo American Dividend Law: American Cases and Statutes, 1929, 29 Col.L.Rev. 461; Weiner, The Amount Available for Dividends Where No Par Shares have been Issued, 1929, 29 Col.L.Rev. 906; Weiner and Bonbright, Theory of Anglo American Dividend Law; Surplus and Profits, 1930, 30 Col.L.Rev. 330, 954; Notes, 1928, 55 A.L.R. 8; 1932, 76 A.L.R. 885; 1937, 109 A.L.R. 1381; 1933, 3 Brooklyn L.Rev. 91, Federal Control over Corporate Distributions to Stockholders under the Public Utility Holding Company Act, 1940, 49 Yale L.J. 492.

tests raise a question whether, even though there may be no surplus, dividends may nevertheless be declared if, despite that fact, there are current net earnings.

Certain states at one time required that dividends be declared *only* out of "net profits arising from the operation of the business"—which would seem to prevent payment of dividends out of paid in surplus, or surplus arising from upward revaluation of the assets of the corporation; and occasionally other restrictions appear, either in statutes or in charter provisions.

The first task of the lawyer is, therefore, to discover whether the statutory or charter conditions permit declaration of a dividend.

In addition to the statutory and charter test, there is a purely business test which is always present in the minds of business men. Dividends are commonly paid in cash; and the payment accordingly depletes the cash or current assets of the corporation. Although it may have ample surplus and ample earnings, its "current ratio"—that is, the amount of cash and current assets in proportion to its current debts and liabilities—may be low. Banks and trade creditors do not look with favor on dividend payments depleting current assets if this raises the possibility current debts may go unpaid. Over-generous dividend policies adversely affect credit-rating.

Another, and purely business consideration, arises out of the fact that shares are widely traded on stock exchanges. A buyer likes to know with great definiteness whether, if he buys stock, a dividend being declared at or about that time is payable to him or to his predecessor in title. In consequence, dividends are commonly declared payable to stockholders of record on a stated date; and advance notice of the "record" of this date, commonly called the "record date" must be sent to the stock exchanges. Sales made prior to the record date give to the purchaser the right to the dividend; sales after that date are "ex-dividend", the dividend being paid to the holder as of the record date.

As a result, most dividend declarations have three dates:

(1) the date on which the dividend was declared by the Board of Directors;

(2) payable to the stockholders of record at close of business on a date stated in the declaration;

(3) the dividend actually being payable at a subsequent date.

Thus the directors of a corporation may meet on December 5, and may then declare a dividend payable to stockholders of record at close of business on December 20, the dividend itself to be payable on January 1.

Manipulation of Dividends

If no questions existed other than those of practice, dividend laws would be fairly simple. But, when a corporation has more than one class of stock, many means exist permitting the directors, by varying the timing of dividends, actually to direct the stream of profits of the corporation towards one or another class of stock.

Thus, a corporation may have non-cumulative preferred stock and common stock. Dividends on non-cumulative preferred stock, under the Federal rule, are payable only if declared in, or in respect of, a particular year; if not declared, that year's dividends are lost to the non-cumulative preferred stockholders. It is true that when non-cumulative preferred dividends are unpaid, common dividends may not be paid in that year to the common stock.

But in the case of a corporation with ample regular earnings to cover non-cumulative preferred dividends and also to pay dividends on common, the directors might adopt a policy of not declaring dividends in every year but only every two years. In that case, in the intermediate years, the dividends on non-cumulative preferred stock would be lost to those stockholders; and would then become available for declaration to the common stock. The result would be to keep down the income received by the non-cumulative preferred to one-half of what it would be if dividends were regularly declared; and the savings thus accomplished could then be declared as dividends to the common stockholders.

With more complex corporate structures, with non-participating preferred and other similar classes of stock, the possibility of manipulation becomes very great. Thus, in addition to the technical problem which arises out of declaration of dividends, there is also an equitable problem: the problem of whether the discretion which directors enjoy to declare dividends is absolute, or whether it is controlled by equitable principles. There is a current of legal opinion that the discretion is not absolute; that directors cannot, from self-interest or whim, exercise their discretion to the detriment of one class of stockholders and in favor of another. But, since the opinion of Mr. Justice Holmes in Wabash Railway v. Barclay and the prevalence of the Federal as against the New Jersey rule, the majority view for the moment appears to be that if the corporate papers permit this manipulation, the stockholders must be taken to have consented to it and what happens to them is their own fault. The conception is inherently so shocking that a lawyer may expect continued resistance to the harshness of the rule.

A second problem arises out of the fact that dividends powerfully affect the market value of stock. Thus on one occasion the directors of a well-established company which had declared dividends regularly for years met on the usual date on which dividends were declared and adjourned without action on the dividend. The natural result was a violent drop in the market value of the stock. Shortly thereafter the directors met again and declared the regular dividend. Query: Whether in this situation directors might not be liable for losses to shareholders who sold at the lower price, unless they could justify their action by valid business reasons?

NEW YORK STOCK CORPORATION LAW

§ 58. *Dividends.* No stock corporation shall declare or pay any dividend which shall impair its capital, nor while its capital is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon a reduction of the number or par value of its shares or of its capital, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities, including capital. In case any such dividend shall be paid, or any such distribution of assets made, the directors in whose administration the same shall have been declared or made, except those (1) who may have caused their dissent therefrom to be entered upon the minutes of the meetings of directors at the time or (2) who having been absent when such action was taken may have communicated in writing their dissent to the secretary or caused their dissent to be entered on the minutes within a reasonable time after learning of such action, or (3) who affirmatively show that they had reasonable grounds to believe, and did believe, that such dividend or distribution would not impair the capital of such corporation, shall be liable jointly and severally to such corporation and to the creditors thereof to the full amount of any loss sustained by such corporation or by its creditors respectively by reason of such dividend or distribution.

DELAWARE GENERAL CORPORATION LAW

§ 34. *Dividends; Reserves:*—The directors of every corporation created under this Chapter, subject to any restrictions contained in its Certificate of Incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of its capital as computed in accordance with the provisions of Sections 14, 26, 27 and 28 of this Chapter, or (b), in case there shall be no such excess, out of its net profits for the fiscal year then current and/or the preceding fiscal year; provided, however, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired. Subject to any restrictions contained in its Certificate of Incorporation, the directors of any corporation engaged in the exploitation of wasting assets may determine the net profits derived from the exploitation of such wasting assets without taking into consideration the depletion of such assets resulting from lapse of time or from necessary consumption of such assets incidental to their exploitation.

Nothing contained in this Section shall prevent the stockholders of any corporation, or the directors thereof if the Certificate of Incorporation shall so provide, from setting apart out of any of the funds of the corporation available for dividends a reserve or reserves for any proper purpose or from abolishing any such reserve in the manner in which it was created.

A director shall be fully protected in relying in good faith upon the books of account of the corporation or statements prepared by any of its officials as to the value and amount of the assets, liabilities and/or net profits of the corporation, or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid.

§ 35. *Dividends; How Declared and Paid; Violations of Section; Penalty; Exoneration from Liability:*—No corporation created under the provisions of this Chapter, nor the Directors thereof, shall pay dividends upon any shares of the corporation except in accordance with the provisions of this Chapter. Dividends may be paid in cash, in property, or in shares of the capital stock, in the case of shares with par value at par, and in the case of shares without par value at such price as may be fixed by the Board of Directors. In case of any willful or negligent violation of the provisions of this Section, the Directors under whose administration the same may happen shall be jointly and severally liable, at any time within six years after paying such unlawful dividend, to the corporation and to its creditors, in the event of its

dissolution or insolvency, to the full amount of the dividend so unlawfully paid, with interest on the same from the time such liability accrued; provided that any Director who may have been absent when the same was done, or who may have dissented from the act or resolution by which the same was done, may exonerate himself from such liability by causing his dissent to be entered at large on the books containing the minutes of the proceedings of the Directors at the time the same was done, or forthwith after he shall have notice of the same, or by causing a true copy of such dissent to be published, within two weeks after the same shall have been so entered, in a newspaper published in the County where the corporation has its principal office.

(a) Contract Obligation to Declare a Dividend (Rare)

AMICK v. COBLE.

Supreme Court of North Carolina, 1943. 222 N.C. 484, 23 S.E.2d 854.

Action by G. L. Amick against W. V. Coble and others, officers and directors of the Central Grocery Company, Inc., to require defendants to pay corporate dividends. From the judgment, plaintiff and defendants appeal.

Affirmed on defendants' appeal; modified and affirmed on plaintiff's appeal.

Civil action to require defendants to pay dividends. Under C.S. § 1178.

[The Central Grocery Company, a corporation, was organized in 1927 by the plaintiff and defendant, W. V. Coble, with a capital paid-in stock of $10,000 composed of 100 shares of $100 par value stock, to carry on the wholesale grocery business. Plaintiff became secretary-treasurer and general manager of the corporation, and continued in that capacity until February 15, 1940; at the end of the year 1939, seventy-eight shares of the capital stock were outstanding,—the other twenty-two shares having been bought in by the corporation and held as treasury stock; also at the end of the year 1939 the corporation had built up a surplus of $39,971.38, in addition to earnings of $5,528.96 in that year, based upon merchandise inventory $38,614.93, as plaintiff contends, or $21,623.89 based upon a merchandise inventory reduced to $29,389.15 as averred by defendants; at a meeting of the board of directors held early in 1940, plaintiff as secretary-treasurer and general manager was superseded by defendant W. V. Coble. For the year 1940, the company showed a net profit of at least $2,636.91; and $2,116.92 in 1941. In 1941, the stockholders and directors set aside $43,500 as working capital; for 1942 they set aside $50,000 for the same purpose. Both sums were found to be more than the surplus existing at the end of the years in question.

Plaintiff, in his complaint, seeks to have all of the surplus accumulated prior to 1940 declared as a stock dividend, and to have the profits for the years 1940 and 1941 paid out in cash dividends.

Upon hearing in Superior Court, a jury trial was waived and it was agreed that the court might find the facts and enter judgment accordingly.

The court found that defendants had no right to set aside the whole surplus as "working capital"; that these sums were far in excess of what could, in good faith, be set aside, and ordered the directors to declare as dividends from profits for the years 1940 and 1941, the sum of $4,278.44.].

WINBORNE, JUSTICE. * * * The statute relating to corporations, Chapter 22, Consolidated Statutes of North Carolina, Section 1178, provides that: "The directors of every corporation created under this chapter shall, in January of each year, unless some specific time for that purpose is fixed in its charter, or by-laws, and in that case at the time so fixed, after reserving, over and above its capital stock paid in, as a working capital for the corporation, whatever sum has been fixed by the stockholders, declare a dividend among its stockholders of the whole of its accumulated profits exceeding the amount reserved, and pay it to the stockholders on demand. * * *

The court finds as a fact that at the beginning of the year 1940 the corporation had a surplus of approximately $44,075, and at the end of year 1941 the surplus was approximately $43,156.14. Also while the court further finds that prior to 1940 the stockholders were paid only small dividends and the earnings were permitted to remain in the treasury of the company and be used in whatever way the corporation needed them, and mainly in the increase of stock of goods, it also finds that no corporate resolution had been adopted with respect to this surplus. Moreover, it appears that no corporate action was taken by the stockholders until after the hearing of this action in the court below, when, at the suggestion, and with the consent of the court, a special meeting of stockholders and of directors was called at the instance of defendants, the stated purpose of which was "to establish the working capital of this company for the year 1942, and to designate by resolution a reserve as working capital for the years 1940 and 1941." And the court finds that at such meeting the stockholders by majority vote set aside as working capital for the year 1941 an amount which is more than the surplus at the end of that year,—before taxes had been paid and a reserve for bad debts set up. Upon this the court in effect holds that the defendants as majority stockholders did not act in good faith. Therefore, if it be conceded that at such meeting the majority stockholders, acting in good faith, could have set aside a working capital after the institution of this action, the ruling below is tantamount to holding that no such action has been taken in good faith. The effect of this is that no valid corporate action has been taken with respect to setting aside a working capital either before or after the institution of this action. Consequently, the accumulated profits are available for dividends, and the directors are controlled by the provisions of C.S. § 1178, and have no discretion with respect to the performance of the duty imposed. Cannon v. Mills Co., supra. But it appears that the plaintiff seeks to have paid in cash only the profits for

the years 1940 and 1941, and there is, therefore, no error in the judgment directing the payment of cash dividends from the profits for those years.

Plaintiff's Appeal: Plaintiff assigns as error the refusal to the court to order paid as cash dividends the whole of the profits for the years 1940 and 1941 as shown in the annual statements rendered at the end of those years, respectively. However, the court finds that the profits shown on the 1940 statement are subject to income tax, to allowance for bad debts, and to inventory adjustment; and that the profits shown on the statement for the year 1941 are subject to income tax and to deduction for bad debts, thereby reducing the total profits for those years to $4,753.83. Manifestly, the income tax, allowance for bad debts, and the inventory adjustment are properly deductible in order to ascertain the net profits. However, we are of opinion that the court erred in allowing ten per cent of the net accumulated profits for 1940 and 1941 to be deducted to cover probable expenses. The order should have directed the payment of the full amount of $4,753.83. That this may be done without impairing the capital structure of the corporation is, on this record, patent. For after paying this amount as dividend, there still remains of the surplus as of the end of the year 1941, the sum of $38,302.31, on a paid-in and outstanding capital of $7,800, as shown by facts found by the court to which no exceptions are presented.

As the court rendered no judgment with respect to the payment of the accumulated profits prior to the year 1940, we make no ruling with regard thereto, and leave the matter for future determination in this action, if any of the parties so move.

On Defendants' Appeal—Affirmed.

On Plaintiff's Appeal—Modified and affirmed.

LYDIA E. PINKHAM MEDICINE COMPANY v. GOVE et al.

Supreme Judicial Court of Massachusetts, 1939. 303 Mass. 1, 20 N.E.2d 482.

Suit by Lydia E. Pinkham Medicine Company against Aroline P. Gove and others for damages and injunctive relief predicated on breaches of trust by defendants as directors and officers of plaintiff corporation. On reservation and report.

Decree for plaintiff in part in accordance with opinion.

QUA, JUSTICE. When this suit came before the full court upon a previous occasion (Lydia E. Pinkham Medicine Co. v. Gove, Mass., 9 N.E. 2d 573) we held that no error had been shown in overruling the defendants' demurrer to the bill and the defendants' plea; that the defendants' exceptions to the master's first report must be overruled; that the plaintiff was entitled to injunctive relief and to damages and costs against the defendants Aroline P. Gove and Lydia P. Gove; that the bill should be dismissed as to the defendant Renehan, with costs

to her; and that upon the entering of the final decree the temporary injunction restraining the defendants Gove from further prosecuting their suit in Maine for the appointment of a receiver of the plaintiff should be dissolved. We then stated in substance that further hearings upon various matters would be necessary before the details of a final decree could be settled and ordered the case to stand for further proceedings in the county court.

Thereafter the cause was recommitted to the master for further findings of fact, and both his first report and his supplemental report have been confirmed. * * *

5. The plaintiff is entitled to have the defendants Gove as directors join in declaring dividends in compliance with a by-law of the plaintiff which reads as follows: "The net surplus of the company shall not be accumulated or maintained to an amount exceeding $1,000,000. Until the net surplus is reduced to $1,000,000 dividends shall be declared and paid to the stockholders out of the current net earnings of the company so far as the same shall be sufficient for that purpose, and the balance, so far as necessary, out of the net surplus of the company, at the rate of $3,000 per share per annum payable in ten equal payments on the first day of each calendar month except January and February. Thereafter so far as consistent with the maintenance of a net surplus of $1,000,000 and unless otherwise voted unanimously by the full board of directors, dividends shall be declared and paid to the amount of the net earnings of the company in ten equal payments each year as above provided." The surplus was "reduced to $1,000,000" but now again exceeds that amount, and the defendants Gove in bad faith and as one means of compelling the Pinkhams to sell their stock have in times past refused to join in declaring dividends.

A question might be raised as to whether the plaintiff is a proper party to seek relief of this kind, inasmuch as it is not shown to have suffered pecuniary loss or damage in its property through the retention of money that ought to have been paid out as dividends. Nevertheless we think it can fairly be held that a corporation has a cause of action when a command like this embodied in its organic law has been violated by its officers. One of the objects of the corporation's existence is to earn money for its stockholders. It is not devoid of interest in the orderly conduct of its affairs. It cannot be wholly indifferent to the continuance of a deadlock which results in one half of its ownership being wrongfully deprived of the income that belongs to the shares. Such a situation is bound to have repercussions affecting the well-being and the future prospects of the corporation itself. So far as we can discover all the decisions recognizing the right to compel the declaration of dividends agree that a shareholder cannot sue without first attempting to move the corporation, unless such attempt would be useless, and that the corporation is at least a proper party to a suit brought by a shareholder. Indeed, it has been asserted more than once that the shareholder's right to have a dividend declared is wholly derivative, and that any suit that he may bring should be brought in behalf of the corporation as for a wrong to the corporation itself. [Citing cases.] * * *

We do not intend to intimate that a bill brought by a stockholder for the benefit of all stockholders would not lie. Such bills have succeeded of this purpose in other jurisdictions. Stevens v. United States Steel Corp., 2 Robb. (N.J.) 373, 59 A. 905. Probably in most instances practical considerations will make this course necessary, as it will seldom happen that a corporation whose directors refuse to declare dividends will itself bring suit. [Citing cases.] * * * But in a case like this one a right to sue in the corporation and a right to sue in the stockholders are not necessarily mutually exclusive, and it is convenient that all issues arising out of the conduct of the defendants Gove should be adjusted in one suit. See Dunphy v. Traveller Newspaper Association, 146 Mass. 495, 499, 16 N.E. 426.

The by-law is a reasonable regulation of the shareholders' rights to receive dividends. The required surplus of $1,000,000 and the requirement limiting the dividends to net earnings protect the interests of the corporation and of its creditors. The by-law is valid, and where the shareholders' rights are definitely fixed by a valid by-law the discretion of the directors is correspondingly limited, and the reasons that have made courts reluctant to order the declaration of dividends lose their force. [Citing cases.] * * * No reason has been advanced why dividends should not be declared and paid regularly in accordance with the by-law. The defendant directors in refusing to declare dividends have not exercised their judgment in good faith.

The requirement that the dividends shall be declared and paid "in ten equal payments each year" on the first day of each month except January and February presupposes the ascertainment before the first day of March in each year of a fixed sum, based upon the then existing financial condition of the corporation, as the "amount of the net earnings" (in excess of the amount required to maintain the surplus at $1,000,000) which is to be divided in equal payments during that year. A sum which varies monthly or even daily cannot be divided into ten equal monthly payments. If during any year it should appear that to continue the payments established at the beginning of the year would reduce the net surplus below $1,000,000 so much of any payment as would have that effect is to be withheld. This is a result of the condition that the equal payments are to be made "so far as consistent with the maintenance of a net surplus of $1,000,000." * * *

Applying these principles to the facts found, we think that the defendants Aroline P. Gove and Lydia P. Gove should be enjoined as follows: * * *

(F) From making or contracting or purporting to contract to make any disposition of moneys or other assets of the corporation except as directed by the board of directors or by the president and from refusing or neglecting or delaying to make or threatening not to make such payments and dispositions of money and assets as the board of directors or the president under the authority of the vote of June 7, 1927, shall direct to be made. * * *

A final decree is to be entered in accordance with this opinion.

Ordered accordingly.

(b) Directors' discretion to declare dividends and limitations on that discretion

DODGE v. FORD MOTOR CO.

Supreme Court of Michigan, 1919. 204 Mich. 459, 170 N.W. 668, 3 A.L.R. 413.

Bill by John F. Dodge and another against the Ford Motor Company and others to compel the declaration of dividends and for an injunction. From the decree rendered, defendants appeal. * * *

OSTRANDER, J. (after stating the facts). The authorized capital stock of the defendant company is $2,000,000. Its capital, in July, 1916, invested in some form of property, including accounts receivable, was $78,278,418.65, and, less liabilities other than capital stock, was more than $60,000,000. Besides this, it had and was using as capital nearly $54,000,000 in cash or the equivalent of cash. * * * [3]

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[3] The following is the balance sheet of the company on July 31, 1916:

Assets	
Working—	
Cash on hand and in bank	$ 52,550,771.92
Michigan municipal bonds	1,259,029.01
Accounts receivable	8,292,778.41
Merchandise and supplies	31,895,434.69
Investments—outside	9,200.00
Expense inventories	434,055.19
Plant—	
Land	5,232,156.10
Buildings and fixtures	17,293,293.40
Machinery and power plant	8,896,342.31
Factory equipment	3,868,261.02
Tools	1,690,688.54
Patterns	170,619.77
Patents	64,339.85
Office equipment	431,249.37
Total assets	$132,088,219.58
Liabilities	
Working—	
Accounts payable	$ 7,680,866.17
Contract deposits	1,519,296.40
Accrued payrolls	847,953.68
Accrued salaries	338,268.86
Accrued expenses	1,175,070.72
Contract rebates	2,199,988.00
Buyers' P. S. Rebates	48,099.00
Reserves—	
For fire insurance	57,493.89
For depreciation of plant	4,260,275.33
Total liabilities	$ 18,127,312.05
Surplus	$111,960,907.53
Capital stock	2,000,000.00
Total	$132,088,219.58

The rule which will govern courts in deciding these questions is not in dispute. It is, of course, differently phrased by judges and by authors, and, as the phrasing in a particular instance may seem to lean for or against the exercise of the right of judicial interference with the actions of corporate directors, the context, or the facts before the court, must be considered. This court, in Hunter v. Roberts, Thorp & Co., 83 Mich. 63, 71, 47 N.W. 131, recognized the rule in the following language:

"It is a well-recognized principle of law that the directors of a corporation, and they alone, have the power to declare a dividend of the earnings of the corporation, and to determine its amount. 5 Am. & Eng. Enc. Law, 1st Ed., p. 725. Courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of the corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud, or breach of that good faith which they are bound to exercise towards the stockholders."

In 2 Cook on Corporations, 7th Ed. § 545, it is expressed as follows:

"The board of directors declare the dividends, and it is for the directors, and not the stockholders, to determine whether or not a dividend shall be declared.

"When, therefore, the directors have exercised this discretion and refused to declare a dividend, there will be no interference by the courts with their decision, unless they are guilty of a wilful abuse of their discretionary powers, or of bad faith or of a neglect of duty. It requires a very strong case to induce a court of equity to order the directors to declare a dividend, inasmuch as equity has no jurisdiction, unless fraud or a breach of trust is involved. There have been many attempts to sustain such a suit, yet, although the courts do not disclaim jurisdiction, they have quite uniformly refused to interfere. The discretion of the directors will not be interfered with by the courts, unless there has been bad faith, wilful neglect, or abuse of discretion.

"Accordingly, the directors may, in the fair exercise of their discretion, invest profits to extend and develop the business, and a reasonable use of the profits to provide additional facilities for the business cannot be objected to or enjoined by the stockholders."

In 1 Morawetz on Corporations, 2d Ed., § 447, it is stated:

"Profits earned by a corporation may be divided among its shareholders; but it is not a violation of the charter if they are allowed to accumulate and remain invested in the company's business. The managing agents of a corporation are impliedly invested with a discretionary power with regard to the time and manner of distributing its profits. They may apply profits in payment of floating or funded debts, or in development of the company's business; and so long as they do not abuse their discretionary powers, or violate the company's charter, the courts cannot interfere.

"But it is clear that the agents of a corporation, and even the majority, cannot arbitrarily withhold profits earned by the company, or apply them to any use which is not authorized by the company's charter. The nominal capital of a company does not necessarily limit the scope of its operations; a corporation may borrow money for the purpose of enlarging its business, and in many instances it may use profits for the same purpose. But the amount of the capital contributed by the shareholders is an important element in determining the limit beyond which the company's business cannot be extended by the investment of profits. If a corporation is formed with a capital of $100,000 in order to carry on a certain business, no one would hesitate to say that it would be a departure from the intention of the founders to withhold profits, in order to develop the company's business, until the sum of $500,000 had been amassed, unless the company was formed mainly for the purpose of accumulating the profits from year to year. The question in each case depends upon the use to which the capital is put, and the meaning of the company's charter. If a majority of the shareholders or the directors of a corporation wrongfully refuse to declare a dividend and distribute profits earned by the company, any shareholder feeling aggrieved may obtain relief in a court of equity.

"It may often be reasonable to withhold part of the earnings of a corporation in order to increase its surplus fund, when it would not be reasonable to withhold all the earnings for that purpose. The shareholders forming an ordinary business corporation expect to obtain the profits of their investment in the form of regular dividends. To withhold the entire profits merely to enlarge the capacity of the company's business would defeat their just expectations. After the business of a corporation has been brought to a prosperous condition, and necessary provision has been made for future prosperity, a reasonable share of the profits should be applied in the payment of regular dividends, though a part may be reserved to increase the surplus and enlarge the business itself."

One other statement may be given from Park v. Grant Locomotive Works, 40 N.J.Eq. 114, 3 A. 162; Id., 45 N.J.Eq. 244, 19 A. 621:

"In cases where the power of the directors of a corporation is without limitation, and free from restraint, they are at liberty to exercise a very liberal discretion as to what disposition shall be made of the gains of the business of the corporation. Their power over them is absolute as long as they act in the exercise of their honest judgment. They may reserve of them whatever their judgment approves as necessary or judicious for repairs or improvements, and to meet contingencies, both present and prospective. And their determination in respect of these matters, if made in good faith and for honest ends, though the result may show that it was injudicious, is final, and not subject to judicial revision."

It is not necessary to multiply statements of the rule.

To develop the points now discussed, and to a considerable extent that may be developed together as a single point, it is necessary to refer with some particularity to the facts.

When plaintiffs made their complaint and demand for further dividends the Ford Motor Company had concluded its most prosperous year of business. The demand for its cars at the price of the preceding year continued. It could make and could market in the year beginning August 1, 1916, more than 500,000 cars. Sales of parts and repairs would necessarily increase. The cost of materials was likely to advance, and perhaps the price of labor, but it reasonably might have expected a profit for the year of upwards of $60,000,000. It had assets of more than $132,000,000, a surplus of almost $112,000,000, and its cash on hand and municipal bonds were nearly $54,000,000. Its total liabilities, including capital stock, was a little over $20,000,000. It had declared no special dividend during the business year except the October, 1915, dividend. It had been the practice, under similar circumstances, to declare larger dividends. Considering only these facts, a refusal to declare and pay further dividends appears to be not an exercise of discretion on the part of the directors, but an arbitrary refusal to do what the circumstances required to be done. These facts and others call upon the directors to justify their action, or failure or refusal to act. In justification, the defendants have offered testimony tending to prove, and which does prove, the following facts. It had been the policy of the corporation for a considerable time to annually reduce the selling price of cars, while keeping up, or improving, their quality. As early as in June, 1915, a general plan for the expansion of the productive capacity of the concern by a practical duplication of its plant had been talked over by the executive officers and directors and agreed upon, not all of the details having been settled and no formal action of directors having been taken. The erection of a smelter was considered, and engineering and other data in connection therewith secured. In consequence, it was determined not to reduce the selling price of cars for the year beginning August 1, 1915, but to maintain the price and to accumulate a large surplus to pay for the proposed expansion of plant and equipment, and perhaps to build a plant for smelting ore. It is hoped, by Mr. Ford, that eventually 1,000,000 cars will be annually produced. The contemplated changes will permit the increased output.

The plan, as affecting the profits of the business for the year beginning August 1, 1916, and thereafter, calls for a reduction in the selling price of the cars. It is true that this price might be at any time increased, but the plan called for the reduction in price of $80 a car. The capacity of the plant, without the additions thereto voted to be made (without a part of them at least), would produce more than 600,000 cars annually. This number, and more, could have been sold for $440 instead of $360, a difference in the return for capital, labor and materials employed of at least $48,000,000. In short, the plan does not call for and is not intended to produce immediately a more profitable business but a less profitable one; not only less profitable than formerly but less profitable than it is admitted it might be made. The apparent immediate effect will be to diminish the value of shares and the returns to shareholders.

It is the contention of plaintiffs that the apparent effect of the plan is intended to be the continued and continuing effect of it and that it is deliberately proposed, not of record and not by official corporate declaration, but nevertheless proposed, to continue the corporation henceforth as a semi-eleemosynary institution and not as a business institution. In support of this contention they point to the attitude and to the expressions of Mr. Henry Ford.

Mr. Henry Ford is the dominant force in the business of the Ford Motor Company. No plan of operations could be adopted unless he consented, and no board of directors can be elected whom he does not favor. One of the directors of the company has no stock. One share was assigned to him to qualify him for the position, but it is not claimed that he owns it. A business, one of the largest in the world, and one of the most profitable, has been built up. It employs many men, at good pay.

"My ambition," said Mr. Ford, "is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business."

"With regard to dividends, the company paid sixty per cent. on its capitalization of two million dollars, or $1,200,000, leaving $58,000,000 to reinvest for the growth of the company. This is Mr. Ford's policy at present, and it is understood that the other stockholders cheerfully accede to this plan."

He had made up his mind in the summer of 1916 that no dividends other than the regular dividends should be paid, "for the present."

"Q. For how long? Had you fixed in your mind any time in the future, when you were going to pay—

"A. No.

"Q. That was indefinite in the future?

"A. That was indefinite, yes, sir."

The record, and especially the testimony of Mr. Ford, convinces us that he has to some extent the attitude towards shareholders of one who has dispensed and distributed to them large gains and that they should be content to take what he chooses to give. His testimony creates the impression also, that he thinks the Ford Motor Company has made too much money, has had too large profits, and that although large profits might be still earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken. We have no doubt that certain sentiments, philanthropic and altruistic, creditable to Mr. Ford, had large influence in determining the policy to be pursued by the Ford Motor Company—the policy which has been herein referred to.

It is said by his counsel that—

"Although a manufacturing corporation cannot engage in humanitarian works as its principal business, the fact that it is organized for profit does not prevent the existence of implied powers to carry on with humanitarian motives such charitable works as are incidental to the main business of the corporation."

And again:

"As the expenditures complained of are being made in an expansion of the business which the company is organized to carry on, and for purposes within the powers of the corporation as hereinbefore shown, the question is as to whether such expenditures are rendered illegal because influenced to some extent by humanitarian motives and purposes on the part of the members of the board of directors."

In discussing this proposition, counsel have referred to decisions such as Hawes v. Oakland, 104 U.S. 450, 26 L.Ed. 827; Taunton v. Royal Ins. Co., 2 Hem. & M. 135; Henderson v. Bank of Australasia, L.R. 40 Ch.Div. 170; Steinway v. Steinway & Sons, 17 Misc. 43, 40 N.Y.S. 718; People ex rel. Metropolitan Life Ins. Co. v. Hotchkiss, 136 App.Div. 150, 120 N.Y.S. 649. These cases, after all, like all others in which the subject is treated, turn finally upon the point, the question whether it appears that the directors were not acting for the best interests of the corporation. We do not draw in question, nor do counsel for the plaintiffs do so, the validity of the general propositions stated by counsel nor the soundness of the opinions delivered in the cases cited. The case presented here is not like any of them. The difference between an incidental humanitarian expenditure of corporate funds for the benefit of the employees, like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious. There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting, minority stockholders. A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.

There is committed to the discretion of directors, a discretion to be exercised in good faith, the infinite details of business, including the wages which shall be paid to employees, the number of hours they shall work, the conditions under which labor shall be carried on, and the prices for which products shall be offered to the public. It is said by appellants that the motives of the board members are not material and will not be inquired into by the court so long as their acts are within their lawful powers. As we have pointed out, and the proposition does not require argument to sustain it, it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders it would not be the duty of the courts to interfere.

We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company. In

view of the fact that the selling price of products may be increased at any time, the ultimate results of the larger business cannot be certainly estimated. The judges are not business experts. It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. The experience of the Ford Motor Company is evidence of capable management of its affairs. It may be noticed, incidentally, that it took from the public the money required for the execution of its plan and that the very considerable salaries paid to Mr. Ford and to certain executive officers and employees were not diminished. We are not satisfied that the alleged motives of the directors, in so far as they are reflected in the conduct of the business, menace the interests of shareholders. It is enough to say, perhaps, that the court of equity is at all times open to complaining shareholders having a just grievance.

Assuming the general plan and policy of expansion and the details of it to have been sufficiently, formally, approved at the October and November, 1917, meetings of directors, and assuming further that the plan and policy and the details agreed upon were for the best ultimate interest of the company and therefore of its shareholders, what does it amount to in justification of a refusal to declare and pay a special dividend, or dividends? The Ford Motor Company was able to estimate with nicety its income and profit. It could sell more cars than it could make. Having ascertained what it would cost to produce a car and to sell it, the profit upon each car depended upon the selling price. That being fixed, the yearly income and profit was determinable, and, within slight variations, was certain.

There was appropriated—voted—for the smelter $11,325,000. As to the remainder voted there is no available way for determining how much had been paid before the action of directors was taken and how much was paid thereafter, but assuming that the plans required an expenditure sooner or later of $9,895,000 for duplication of the plant, and for land and other expenditures $3,000,000, the total is $24,220,000. The company was continuing business, at a profit—a cash business. If the total cost of proposed expenditures had been immediately withdrawn in cash from the cash surplus (money and bonds) on hand August 1, 1916, there would have remained nearly $30,000,000.

Defendants say, and it is true, that a considerable cash balance must be at all times carried by such a concern. But, as has been stated, there was a large daily, weekly, monthly, receipt of cash. The output was practically continuous and was continuously, and within a few days, turned into cash. Moreover, the contemplated expenditures were not to be immediately made. The large sum appropriated for the smelter plant was payable over a considerable period of time. So that, without going further, it would appear that, accepting and approving the plan of the directors, it was their duty to distribute on or near the first of August, 1916, a very large sum of money to stockholders.

In reaching this conclusion, we do not ignore, but recognize, the validity of the proposition that plaintiffs have from the beginning profited by, if they have not lately officially, participated in, the gen-

eral policy of expansion pursued by this corporation. We do not lose sight of the fact that it had been, upon an occasion, agreeable to the plaintiffs to increase the capital stock to $100,000,000 by a stock dividend of $98,000,000. These things go only to answer other contentions now made by plaintiffs and do not and cannot operate to estop them to demand proper dividends upon the stock they own. It is obvious that an annual dividend of sixty per cent. upon $2,000,000 or $1,200,000, is the equivalent of a very small dividend upon $100,000,000, or more.

The decree of the court[4] below fixing and determining the specific amount to be distributed to stockholders is affirmed. In other respects except as to the allowance of costs, the said decree is reversed. Plaintiffs will recover interest at five per cent. per annum upon their proportional share of said dividend from the date of the decree of the lower court. Appellants will tax the costs of their appeal, and two-thirds of the amount thereof will be paid by plaintiffs. No other costs are allowed. * * *[5]

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[4] The directors of the Ford Motor Co. were ordered to declare a dividend of $19,275,385.96. A permanent injunction was issued prohibiting: the company from owning, holding or operating any smelting plant or blast furnace; the increase of the fixed capital assets; the holding of liquid assets beyond what might reasonably be required for the operation of the company; and the corporation and its directors were ordered to declare and distribute as dividends any such excess which might now exist or might accrue in the future.

[5] Note, 1919, 17 Mich.L.Rev. 502; 1920, 20 Col.L.Rev. 93; 1919, 28 Yale L.J. 710.

Following the above litigation, in 1919, the minority stockholders sold out to Henry and Edsel Ford, who thus became sole owners of the Ford Motor Co. For the history of this transaction, see James Couzens, 11 B.T.A. 1040, 1928.

MORRISON v. STATE BANK OF WHEATLAND et al.

Supreme Court of Wyoming, 1942. 58 Wyo. 138, 126 P.2d 793.

Action by Margaret Morrison and H. W. Loomis against the State Bank of Wheatland and others to compel defendants to declare and pay a dividend. The case was ordered dismissed as to plaintiff H. W. Loomis, and from a judgment for defendant, plaintiff Margaret Morrison appeals.

Affirmed.

[Action was brought against the State Bank of Wheatland, Josephine Brice, Paul H. Toy, A. L. Kendig and Oscar O. Natwick, as members of the Board of Directors, to compel them to declare and pay a dividend of not less than $600 per share upon the outstanding capital stock of said bank. It was alleged that the defendant bank should and could have paid during the years from 1936 to 1940 substantial cash dividends but did not do so because of an ulterior and dishonest motive of the defendant Directors Brice, Kendig and Toy to gain control of defendant bank and acquire ownership of all its assets for a grossly inadequate consideration, by buying up all of the outstanding shares of capital stock; that this scheme was conceived by the defendant Brice and that the defendants Toy and Kendig actively joined and participated and the defendant, Natwick, being in fact only a dummy Director, unwittingly contributed to this scheme; that the defendant Brice, immediately upon her becoming a Director, began the pursuit of this scheme to control the bank and the Board of Directors and to make it possible for defendants to buy up for a grossly inadequate price the outstanding shares of capital stock, while concealing the actual value of the shares of capital stock and the amount, character and assets of the defendant bank; that in pursuit of this policy defendant Brice ordered a transfer of five shares belonging to Toy to Natwick, who in 1936 became a Director; she purchased about 212 outstanding shares from various estates and individuals for a fixed price of $200 per share, and no dividends were paid from 1936 to 1940 because of the alleged conspiracy; that the defendant Brice entered into an agreement or understanding with Kendig early in 1937 whereby Brice was to obtain and turn over to Kendig a substantial block of the capital stock which she was to deliver to him at $200 per share and that he was, after the stock purchases were made, to become a Director and Executive Vice President of the then bank but his connection with the scheme was to be concealed during the stock buying campaign. The defense was a general denial and a statement of the bank's policy to build up a large surplus.]

METZ, District Judge. * * * The trial lasted several days. At the close of plaintiff's evidence, the defendants jointly and severally moved the court for judgment. Their motion was sustained by the court and judgment was entered as prayed for, and it is from this judgment that the plaintiff has taken her appeal to this court. * * *

The main question involved in this litigation is: "Did the directors of this bank fail or refuse to declare dividends upon the stock of the bank for the sole purpose of depreciating the value of the bank stock

and compelling a sale of the same by different individuals to some of the directors, and has the plaintiff proven the allegations of her petition?" This is the first time the question of requiring the payment of dividends by a bank has been before this court for its consideration.

Hundreds of cases may be cited showing that the law is well settled as to the rights of stockholders and the duties and responsibilities of directors in the average private corporation, but cases involving the demand for the payment of dividends by a bank are, in comparison, few.

The general rule in regard to the payments of dividends by a corporation is thus stated in 18 C.J.S., Corporations, § 466, p. 1106: "The mere fact that a corporation has a large amount of surplus or net profits does not entitle the stockholders to the payment of dividends. When a corporation has net or surplus profits, unless some restraint is imposed by statute, charter, by-laws, contract, or otherwise, whether a dividend shall be declared and, if declared, its amount, rest in the sound discretion of the directors. Generally speaking, the courts have no right to declare dividends, and in the exercise of their discretion directors will not be controlled or interfered with by the courts, unless they act fraudulently, oppressively, or unreasonably."

The rule is also well stated in Cook on Corporations, 7th Ed., p. 1587: "The discretion of the directors will not be interfered with by the courts unless there has been bad faith, wilful neglect, or abuse of discretion."

As indicated before, this case is predicated upon an alleged conspiracy, fraud, and bad faith on the part of the directors, and particularly on the part of Josephine Brice. The record in this case is quite voluminous, involving some thousand pages. The history of this bank is interesting, and perhaps portrays the trials and tribulations of the average bank doing business in a small town, depending upon the farmers and stockmen for its business, they in turn depending upon an uncertain water supply, sudden and depressing fluctuating livestock values for their income, and contending with several years of drouth and a national depression. * * *

By March, 1933, the bank had a $40,000 capital, a $60,000 surplus, and had set aside a $284,000 special working fund, all of this having been plowed back into the capital structure by the directors, of whom the plaintiff's father was a moving party, and from whom the plaintiff inherited her stock.

Then the drouth, lack of water, crop failures, depleted farm and livestock values, hit the Wheatland country, and within a few months the bank's loans became more and more frozen, and, the directors of the bank desiring to become a member of the Federal Reserve System and to secure Federal Depository insurance, it was examined by both Federal and State Bank Examiners. The examiners gave this bank a thorough examination and compelled the directors of the bank to charge off $190,000 of bad loans and assets, and to set up a special reserve of $100,000 to cover additional doubtful and slow paper then held by the bank. The bank examiners further informed the directors

that this $100,000 special reserve fund was not to be used or in any manner reduced without special permission from the State Bank Examiner's office. * * *

It is of interest to note that D. W. Brice's death occurred about a year and a half after this $190,000 charge-off was made by the Examiner; and we take it as a matter of course that these officers and directors had learned about this required action by the Examiners. No wonder these new directors were cautious about dividends and desired to build up the reserves, and especially so considering the drouth and water shortage the community was suffering. It is not necessary for us to comment on the losses of livestock and crops during these two or three years, as indicated by this record. The drouth was general and was not confined to the Wheatland community. The Western states were all having their troubles. We wonder what would have happened in 1933, when this $190,000 was charged off, if the policy of the bank had not been to maintain a large reserve. It probably would have been closed, and another bank failure added to the list. * * * There is no question but what this bank, in 1939, at the time the demand was made by the plaintiff, that the directors declare a dividend, had good-sized reserves, and also that if the directors felt that in their opinion a dividend should have been declared, it could have been paid without any criticism. But that is not the point involved in this litigation. We are not concerned about how large the reserves are, only as indicating the feasibility of a dividend. The payment of dividends is entirely a matter for the board of directors, if they are acting in good faith. The courts do not step in, dictate to directing boards how to run their business, or substitute the court's judgment for the judgment of the governing body of the corporation. Only in extreme cases, and then only where the evidence is clear, satisfactory and convincing that the directors are acting either in a fraudulent manner, or with ulterior motives, will the court interfere.

"There is no rule of law which prevents one or more persons from purchasing a majority of the shares of a corporation for the purpose of acquiring control thereof." 18 C.J.S., Corporations, § 496, p. 1174.

And the above rule of law applies even when the purchase of its stock is made by an officer or director of the corporation. See 84 A.L.R. 618, and authorities cited. In regard to this, the author of the annotations says: "The general rule * * * is that an officer or director of a corporation does not sustain a fiduciary relation to an individual stockholder with respect to his stock, and consequently the mere failure on the part of such officer or director, in purchasing the shares from the stockholder to disclose any inside information, will not militate against him so long as he does not actively mislead the seller or perpetrate a fraud; in other words, ordinarily, a corporate officer or director has a right to purchase the stock of a shareholder therein, the same as any other person has a right to purchase such stock, and there is nothing in the mere fact that the purchaser is an officer or director of the corporation whose shares he purchases from which fraud or unfair dealing may be inferred."

There are a few cases holding to the contrary, but the above rule is sustained by the overwhelming weight of authority. * * *

It is quite apparent from reading this record that these new directors, and particularly Mrs. Brice, did not know the value of the stock in this bank. The physical condition as testified to by Wilde, Christensen, Bertagnolli, and herself, shows that even an expert would have had considerable difficulty in arriving at the actual value of the stock in this bank. All of their acts, under the conditions as they existed at that time, between 1935 and 1939, taking into consideration the unsettled conditions, drouth, lack of water, depreciated livestock values, can be more reasonably construed as being in good faith and being cautious, rather than indicating fraud.

The plaintiff contends that this case comes under the "special circumstance rule," which applies to cases where the court can say that false representations were actually made, or there were special circumstances of such a nature that the court regarded the purchasers' conduct or failure to make full disclosure as fraudulent in law, or where a director as purchaser, knowingly makes only a partial disclosure to a stockholder seeking information amounting under the circumstances, to a fraudulent concealment. See "Stock purchase by officer or director," 84 A.L.R. 623, subdivision III, with authorities cited therein. * * *

The plaintiff's brief is largely devoted to charges of a conspiracy and concealment, fraud, wrongful or arbitrary abuse of discretionary powers, etc., against these defendants, in not declaring a dividend and in the purchase of different stock certificates throughout 1936 and 1937, and in fact up to 1939. The record discloses that the board of directors' acts for several years between 1935 and 1939 were approved at the annual stockholders' meetings, usually by unanimous vote; also all charge-offs by any officer were approved by the board at a later meeting of the directors.

Also, in speaking of dividends, the dividends that were paid in 1940 and 1941, after this case was started, were derived from money realized and recovered from the paper charged off and from land sales. These defendants all testified that Mrs. Brice never tried to control or influence their actions on the board; in fact the evidence shows that Josephine Brice did not take a particularly active part in the bank's business, and the managing of the bank was left to Kendig and Toy and Gans. There is no evidence to show that Josephine Brice knew anything about banking. In fact, the evidence is to the contrary. It might be noted also that the plaintiff in this case was one of the judges of the annual stockholders' election in 1941 and admitted voting for all of these defendants for directors, this occurring subsequent to the filing of this law suit.

The different purchases of stock by Mrs. Brice occurred through 1935 to 1937. * * * The record further discloses that in a number of estates, appraisers appointed by the court in fixing the value of the bank stock, appraised it at from $100 to $150 a share. In fact, the D. W. Brice estate stock was appraised at $150 a share in the estate proceedings, and Josephine Brice, in purchasing stock from different

individuals, paid $200 a share for the stock, and offered it for the same figure to any satisfactory party that would come in and manage the bank. * * *

In some instances very little, if anything, was said about the purchase and the sale, an offer of $200 was made and no statement was made about the bank's condition, and later the party came back and offered to sell for $200 and was paid that amount. An examination of this record in our minds discloses the absence of any fraudulent representation whatsoever by any defendant. The trial judge heard all the evidence from the witnesses and had a good opportunity to analyze their testimony and demeanor while on the stand. The plaintiff failed to convince him that there had been any fraud or conspiracy practiced by any defendant on anyone whatsoever. The plaintiff admits having received at least 350% in dividends on her stock since she inherited it, in 1927. The bank's policy for more than 25 years prior to the time these defendants became interested in the bank was to maintain large reserves, and it is true they paid splendid dividends at times. In fact, the dividends would average around 25% a year over that period of time.

We do not feel that the facts or the law would warrant us in ordering this board of directors to declare a dividend simply because it has a good sized surplus and reserve, and even a larger reserve than most banks carry. The State Examiners testified that because of the peculiar situation that existed in the Wheatland community, and had for years, they suffered a 10% larger charge-off than the average bank in Wyoming, and that also because of these conditions mentioned, it was necessary for this bank to carry a much larger surplus and undivided profits account than other banks of like size in the state of Wyoming.

It is our duty, as we see it, to encourage directors in banks to build up their capital structure until it is unassailable. A bank is not an ordinary private corporation in which the stockholders are the only interested parties. The directors in a bank are the trustees of the funds of the whole territory it serves. Nothing can so wreck a community, or cause as much hardship, misery and heartaches, as a bank failure. The community is a great deal more interested in the safety and solvency of a bank than are stockholders who own a small minority interest. It is the sacred duty of all bank directors and officers to protect their depositors first, and their stockholders last. Too many banks throughout Wyoming have failed because they did not build up their capital structure before declaring dividends.

The conditions that face the officers of our banks today are not particularly encouraging, with taxes pyramiding, inflation and its aftermath just around the corner, a world war that is being financed by the United States and its banks, the uncertainties of the war, the disruption of the community's business and social life and its personnel, all add to the worries and uncertainties and make the decisions of boards of directors in banks arduous and more difficult. It is far better for the directors to be safe rather than sorry.

The decision of the lower court is affirmed.

HARRY CHANNON v. H. CHANNON COMPANY et al.

Appellate Court of Illinois, 1920. 218 Ill.App. 397.

MR. JUSTICE O'CONNOR delivered the opinion of the court.

Harry Channon, a stockholder of the H. Channon Company, a corporation, filed his bill in this case against the corporation and the directors of it praying that an account of the financial condition of the company be had and a cash dividend declared. Complainant contended that the action of the board of directors in refusing to pay a dividend was unjustifiable and arbitrary. The case was referred to the master who took the evidence and reported that the company was in good financial condition; that its financial ability to pay a dividend was admitted, and that the refusal of the directors to a declare a reasonable dividend was arbitrary, unjustifiable, and a denial of the right of minority stockholders to share in the profits of the company.

He recommended that a decree be entered as prayed for requiring the payment of a 10 per cent cash dividend. The findings and recommendations of the master were approved by the chancellor and a decree entered accordingly, to reverse which the corporation and two of the directors prosecute this appeal.

The record discloses that defendant company was incorporated January, 1883, with a capital stock of $100,000, divided into 1,000 shares of the par value of $100 each. The object of the corporation was to manufacture rigging, sails, canvas goods and other merchandise usually dealt in by ship chandlers; that in April, 1913, the capital stock was increased to $1,000,000, divided into 10,000 shares of the par value of $100 each; that from the time of the incorporation of the company down to the present it has been engaged in the business for which it was incorporated. The stock of the company is substantially all held by the Channon family as follows: Henry Channon, the father, 5,400 shares; Elizabeth Channon, his wife, 819 shares; the complainant, Harry Channon, a son, 981 shares; James H. Channon, a son 781 shares; Mrs. Grace C. Bortell, a daughter, 819 shares. John L. Hanley, the secretary of the company, owns 50 shares. Employees of the company own 310 shares, and 840 shares are in the treasury of the company unissued. It appears that the business was founded by the father and that he has always been the dominating factor of it although at the time of the hearing he was about 82 years old. He is president, treasurer and a director of the company. John L. Hanley is the secretary and also a director. James H. Channon is the other director. Cash dividends have been declared and paid as follows: 1911, 10 per cent; 1912, 15 per cent; 1913, 4 per cent; 1914, 2 per cent, making a total of $85,000 paid in dividends. On January 15, 1917, a meeting of the board of directors was held. James H. Channon moved that a dividend be declared at such rate as the directors should consider reasonable. The motion was defeated without any discussion by the votes of Henry Channon and Hanley, the secretary. On February 6 following the bill was filed.

There is no dispute as to the financial standing of the company as shown by the balance sheet of January 1, 1917, from which it appears that the company had on that date in cash, $151,287.81. The company owns real estate valued at $113,769.38. In the statement there is shown a reserve of $75,000 for depreciation of stock on hand, and also a reserve of $100,000 for a building fund; that the net sales for the year 1916 amounted to $2,115,573.49, and the net profits for that year were $341,215.85. On December 31, 1916, the company had on hand merchandise valued at $526,497.45; that it owed current bills amounting to $66,626, and also $41,227.24 to Henry Channon, which he had left in the company's treasury for several years and for which he was paid interest. The evidence tended to show that there was a turnover of the merchandise two or three times per year; that there was no justification for the $75,000 reserve for depreciation; that such reserve had never been made before and instead of any decrease in the value of the goods on hand, they had increased and would continue to increase in value. In reference to the $100,000 reserve for the building fund, the court found that while there had been some talk of procuring a new site nothing had been done in this regard for the past 3 or 4 years. The evidence also tends to show that the real estate held by the firm, although in the name of Henry Channon, had been so held for a number of years contrary to the statute of this State, and that it could be sold for $100,000.

It is the theory of the complainant that the reserve of $75,000 for depreciation of the stock on hand, and of $100,000 for a building fund was simply a subterfuge to avoid the payment of a dividend. There is evidence that the father, Henry Channon, who dominated the conduct of the business, had stated that he would never declare any further dividend while he lived, and that Hanley, a director, was completely dominated and controlled by him. Defendant's position is that the question whether a dividend should be declared rests in the discretion of the board of directors, and in the absence of proof of fraud or breach of trust a court of equity is without power to decree the payment of a dividend. As a general proposition, the action of the board of directors in refusing to declare a dividend is final, and such discretion will not be interfered with by a court of equity in the absence of bad faith or arbitrary or unjustifiable conduct. Cratty v. Peoria Law Library Ass'n, 219 Ill. 516, 76 N.E. 707. But the power of a court of equity to order the directors of a trading corporation to declare and pay a dividend from the unused profits when they have improperly refused to do so is undoubted. Laurel Springs Land Co. v. Fougeray, 50 N.J.Eq. 756, 26 C. 886; Scott v. Eagle Fire Ins. Co., 7 Paige (N.Y.) 198; Morawetz on Corporations (2nd Ed.), sec. 447; 2 Clark & Marshall on Corporations, sec. 517; 6 Fletcher's Cyclopedia of Corporations, sec. 3656. A trading corporation is organized and carried on primarily for the profit of the stockholders and it would be a strange rule indeed if the board of directors could arbitrarily refuse to pay dividends when the financial condition of the company would warrant it. In the instant case there is outstanding 9,160 shares of stock of the par value of $916,000, 10 per cent of which is $91,600. Upon a

consideration of the entire record we find that it is undisputed that the company was transacting a large and lucrative business. There is no dispute that it was amply able to pay the dividend decreed without in any way impairing its financial condition. We think the refusal of the board of directors to declare and pay a dividend was unjustifiable and arbitrary. In these circumstances a court of equity may intervene to compel the directors to declare and pay a dividend as was done in the instant case.

The decree of the superior court of Cook county is affirmed.

NOTE

Equity will order corporate directors to pay accrued dividends on cumulative preferred shares where they have abused their discretion in refusing to declare annual dividends. O'Neall v. O'Neall, 108 Ind.App. 116, 25 N.E.2d 656, 1940, 28 Geo. L.J. 1135, 15 Ind.L.J. 575.

2. EFFECT OF DECLARATION; REVOCABILITY

KING v. PATERSON & H. R. R. CO.

Court of Errors and Appeals of New Jersey, 1861. 29 N.J.L. 504.

THE CHANCELLOR. The action is brought to recover the amount of two dividends, declared in January and July, 1857, upon two hundred shares of the capital stock of the corporation owned by the plaintiffs. The dividends were made payable at the branch office of the Ohio Life Insurance and Trust Company, in the city of New York, the trust company being appointed registers of the railroad company to transfer stock and to pay dividends. Notice of the dividends and of the time and place of payment was published in a newspaper printed and published in the city of New York. The money to pay the dividends was deposited by the defendants in the office of the trust company, before the day of payment of each of said dividends, ready to be paid to the plaintiffs on their application. The money was left in the hands of the trust company until the 24th of August, 1857, when the company failed, and the money was lost.

After a dividend is declared, all community of interest in relation to such dividend, as between the stockholders themselves and between the stockholders and the corporation, is at an end. The right of a party to whom the dividend is payable is recognized as a separate and independent right, which may be enforced as against the corporation. Davis v. Bank of England, 5 Barn. & Cress. 185; Coles v. Bank of England, 10 Ad. & E. 437; Carlisle v. South Eastern Railway Co., 6 English Rail. Cas. 685; 1 Shelf. on Rail. 205. * * *

The true principle is, that the dividend, from the time that it is declared, becomes a debt due from the corporation to the individual stockholder, for the recovery of which, after demand of payment, an action at law may be maintained. State v. Baltimore & Ohio Railway, 6 Gill., Md., 363; Philadelphia, Wil. & Balt. Railway v. Cowell, 28 Pa. 329, 70 Am.Dec. 128; Ohio City v. Cleveland & Toledo Railway, 6 Ohio St. 489.

Like any other debt, it may be set off against the debt of the stockholder to the corporation. Bates v. New York Insurance Co., 3 Johns. Cas., N.Y., 238; Rogers v. Huntingdon Bank, 12 Serg. & R., Pa., 77.

It may be, by banking corporations, sometimes carried to the general account of the stockholder with the corporation, and is thus applied in adjusting balances between the parties or in satisfying the claims of the corporation against the stockholder. They thus act in the character not of trustees, but of debtors. The fund is dealt with not as a trust fund, but as money due. And why should it not be so regarded? What principle is violated? Does not sound policy require that the relation between the stockholder and the corporation in relation to the dividend should be simply that of debtor and creditor; that the stockholder should have his remedy at law, and that the corporation should be permitted to apply it by way of set-off to satisfy demands against the stockholder? * * *

The debt is strictly demandable and to be paid at the office of the corporation. Admitting the right of the corporation to make it payable elsewhere, it must be done at the risk of the corporation. The debtor has no right, without the consent of the creditor, express or implied, to intrust a third party with the fund for the purposes of payment. The trust company with whom the funds were deposited for payment was the agent of the corporation, not of the stockholders; of the debtor, not of the creditor. If the agent prove faithless, or the fund is lost in his hands, the loss must fall upon the owner. The deposit was made in the name of the corporation, and was subject to their control. There is nothing in the special verdict that shows a consent, express or implied, on the part of the plaintiffs to their funds being intrusted to, or deposited with, the Ohio Life and Trust Company.

Strong considerations in support of this conclusion may, perhaps, as was urged upon the argument, be derived from the peculiar provisions of the charter of the railroad company, as well as from the policy of the law, which would deny to a corporation within this state the right to deposit moneys due to its creditors in the hands of a foreign corporation. But the decision is designedly based upon the sole ground, that after a dividend is declared, it becomes a debt due from the corporation to the stockholder as an individual, and that the selection of an agent for the payment of that debt by the debtor without the concurrence of the creditor must be at the risk of the debtor alone. The fund remains the property of the corporation until payment is made. If a loss is sustained, it falls upon the owner.

The judgment must be affirmed.

NOTE

A debtor-creditor relation exists between a corporation and its stockholders after a dividend is declared, and the stockholder may maintain an action at law to recover the sum due any time after the date is fixed for the payment of each dividend. The Statute of Limitations begins to run against such action from the time the dividend becomes payable. Jacques and Stoddard v. White Knob Copper & Development Co., Ltd., 260 App.Div. 640, 23 N.Y.S.2d 326, 1st Dep't., 1940

STAATS v. BIOGRAPH CO.

Circuit Court of Appeals of the United States, Second Circuit, 1916.
236 F. 454, L.R.A.1917B, 728.

In Error to District Court of United States for Southern District of New York.

Action at law by Richard H. Staats against the Biograph Company. Judgment for defendant, and plaintiff brings error. Affirmed.

The defendant is a corporation organized in 1895 pursuant to the laws of the state of New Jersey. It has an authorized capital of $2,000,000, and of this amount $1,000,000 is outstanding, and is engaged in the moving picture business.

The plaintiff is a citizen of the state of New York and is the record owner of 550 shares of the par value of $55,000 of the stock of the defendant company, and has been since prior to January 1, 1913.

On December 28, 1914, the board of directors of defendant declared a dividend of 50 per cent. on its outstanding capital stock, payable February 1, 1915, to the stockholders of record of January 18, 1915. The dividend as declared was payable February 1, 1915. It was to be paid in registered scrip certificates containing upon their face an agreement by the defendant that they might be converted on or before December 21, 1916, at par, without interest, wholly or partly in cash, wholly or partly at par, or wholly or partly in such form of interest-bearing obligation as might be deemed by the directors to the best interests of the company. Announcement of this action was made in a circular to the stockholders, dated December 28, 1914.

Without authorization from the stockholders and on August 10, 1915, and without the plaintiff's consent, the directors passed a resolution rescinding the declaration of the dividend previously declared, and this action was announced in a circular to the stockholders dated August 26, 1915.

On September 14, 1915, the plaintiff made a demand on the defendant for the delivery of the registered scrip certificates which he claimed pursuant to the Resolution of December 28, 1914. The demand was not complied with, and this action is brought to recover $27,500; that being the face amount of the scrip certificates which were issuable to him in respect of the $55,000 par value of the stock held by him. At the close of the trial of the action a motion was made to dismiss the complaint. That motion was denied. Both sides asked the court to direct a verdict, and a verdict was directed for the defendant; an exception being reserved for the plaintiff.

ROGERS, CIRCUIT JUDGE (after stating the facts as above). The question involved herein concerns the power of a board of directors of a corporation to rescind a resolution declaring a scrip dividend, after the resolution declaring the dividend has been announced, and notwithstanding the existence of a surplus at the time of the adoption of both resolutions.

It is conceded that no dispute as to the facts exists. The decision below was limited by its terms to a decision against the plaintiff on questions of law alone.

Prior to 1913 the defendant company had paid cash dividends at the rate of 12 per cent. annually; but on February 28, 1913, the directors decided to reduce the rate to 6 per cent. annually.

The company had purchased land in the Bronx borough in New York City, upon which it proposed to construct a new plant. The reduction in the dividend was for the purpose of facilitating the completion and equipment of this new plant. On December 31, 1912, the company had a surplus of $831,149 after deducting a reserve for depreciation. All of this surplus was profit earned by the company in excess of dividends paid to the stockholders. The balance sheet of the company on June 30, 1915, shows that there was on that day a profit and loss surplus of $1,010,169.83. The evidence shows that at the end of every month during the year of 1915 the surplus always was in excess of $1,000,000. Nevertheless on August 10, 1915, the board adopted the following resolution:

"Resolved, that the action taken at the meeting of the board of directors held December 28, 1914, declaring a scrip dividend of fifty (50) per cent., be and the same is hereby rescinded."

It is not claimed that the corporation had between the time of the declaration of the dividend and its rescission suffered any unforeseen or material loss. All the surplus which existed when the resolution declaring the 50 per cent. scrip dividend was passed still existed when the revoking resolution was adopted and in fact at the time the latter resolution was passed the surplus had been somewhat increased above what it was when the original declaration was made, and at no time since has it fallen below $1,000,000.

But it appears that intermediate to the passage of the resolution declaring the dividend, December 28, 1914, and its rescission, August 10, 1915, the business of the company was seriously affected by the European War. Conditions had so changed that the officers of the company voluntarily consented that their salaries should be reduced. On his own request the president's expense allowance of $7,500 per annum was discontinued, and his salary, which had been $18,750 a year, was reduced to $15,000. The company had to borrow cash from its directors to meet its needs. The operating expenses of the company were about $50,000 a week. A few days prior to the adoption of the rescinding resolution, it borrowed from its president $27,000, who with others accepted the notes of the company unsecured by any collateral. * * *

This seems to be an attempt on the part of a single stockholder to dictate to a directorate and to compel it against its will and honest judgment to pay a dividend to him in cash or stock. The general rule is well established that, when a corporation has a surplus, whether a dividend shall be made rests in the fair and honest discretion of the directors, uncontrollable by the courts. Williams v. Western Union Telegraph Co., 93 N.Y. 162; Gibbons v. Mahon, 136 U.S. 549, 565, 10 S.Ct. 1057, 34 L.Ed. 525, 1890.

There have been numerous attempts to induce courts to interfere with directors in the exercise of their discretion, but they have quite uniformly refused to do so, unless it appeared that the directors had wilfully abused their discretion and acted in bad faith and in neglect of duty. It takes a very strong case to induce a court to order directors to declare a dividend. A court has no jurisdiction to do so unless fraud or a breach of trust is involved. Cook on Corporations, 7th Ed., vol. 2, § 545, p. 1588.

In the case at bar there is nothing to lead us to doubt the perfect honesty and good faith of this board of directors, and the soundness of their judgment in this matter. But this plaintiff is not in this court asking us to compel the board of directors to declare a dividend. He is here, he asserts, because the board has declared the dividend and announced it, and then recalled its action and rescinded the vote.

In proper cases courts protect minorities, even minorities of one against the oppression of the majority of stockholders and of boards of directors. It sometimes happens, however, that a minority institute "strike" suits and seek to oppress majorities and to involve the corporation itself in disaster for purposes of their own and for reasons not always revealed. So that there are cases in which courts are compelled to protect minorities against majorities and majorities against minorities.

In this case it does not escape observation that the plaintiff's right to a stock dividend, if he has such a right and can enforce it, would gain him nothing. We say it would gain him nothing, because while a stock dividend would increase the number of his shares, it proportionately diminishes the value of each of his shares, leaving the aggregate value as it was before. He acquires the ownership of more shares, but he adds nothing to his proportionate ownership of the assets of the corporation. Green v. Bissell, 79 Conn. 547, 555, 65 A. 1056, 8 L.R.A.,N.S., 1101, 118 Am.St.Rep. 156, 9 Ann.Cas. 287, 1907. What he expects through this suit is not the stock but the cash value of the stock. But the question which this court must pass upon, whatever the consequences in this particular case may be, is whether a board of directors, having declared the dividend in the form already stated, had the power to rescind its action.

We may, however, remark in passing that while it might be very disastrous to the welfare of the defendant, under the circumstances in which it now finds itself, if any large number of its stockholders could come into a court of law as this plaintiff has done and enforce the demand that they receive the value of the stock dividend as declared, yet the corporation might easily have avoided any such situation. For we confess our inability to see how the corporation or its stockholders could in the least degree have been prejudiced if the scrip dividend had been issued as originally voted, and the corporation had then elected to pay it in stock. The property of the corporation would not have been impaired in the slightest extent.

The right to reconsider the declaration of a dividend would seem to depend upon the circumstances under which the dividend was declared, as well as upon the character of the dividend itself.

1. If a board of directors, for example, should declare a dividend, and, before any public announcement of the action has been made, should reconsider the vote and rescind the action, its right to do so, perhaps, could not successfully be challenged.

2. If a board of directors should declare a dividend when there are at the time the declaration is made no profits to divide, and if public announcement of the declaration of the dividend should be made, it may be that the right to reconsider and rescind would not be denied. Until such a dividend is paid there would seem to be a locus poenitentiae, and the directors might recall their ultra vires act. They would not be under any obligation to consummate an illegal act which is merely in fieri. Thompson on Corporations, vol. 2, § 2135.

3. But if a board of directors should declare a cash dividend and make a public announcement of the fact, the courts have held that thereafter the board has no right to reconsider and rescind its action. The reason seems to be that the declaration of the dividend sets apart from the profits of the corporation a sum which is to be paid to the stockholders in proportion to their shares, and that it creates a debt due from the corporation to each shareholder, resulting in the relation of debtor and creditor. A dividend divides the property which belongs to the corporation into that which the corporation retains and that which the corporation agrees to pay to the stockholders, and which it is thereby bound to pay. That which one person is bound to pay to another is a debt. Lockhart v. Van Alstyne, 31 Mich. 76, 78, 18 Am.Rep. 156, 1875. Such a dividend cannot be rescinded because a debtor does not have it within his power to "rescind" his debt. Beers v. Bridgeport Spring Co., 42 Conn. 17, 1875; King v. Paterson & H. L. R. Co., 29 N.J.L. 82, 87, 1860; Ford v. Easthampton Rubber Thread Co., 158 Mass. 84, 32 N.E. 1036, 20 L.R.A. 65, 35 Am.St.Rep. 462, 1893; Cook on Corporation, 7th Ed., vol. 2, § 541, p. 1580. And sometimes the corporation becomes not merely a debtor, but is a trustee, as where the corporation has not only declared a dividend, but has deposited a fund out of which the dividends are to be paid. LeRoy v. Globe Insurance Co., 2 Edw.Ch., N.Y., 657, 1836; Van Dyck v. McQuade, 86 N.Y. 38, 52, 1881. A trust relation, having been established, cannot be terminated at the pleasure of the board of directors by a vote rescinding its former action.

In Taylor on Corporations, 5th Ed., § 568, it is said that:

"The discretion of the corporate management is exhausted in declaring the dividend; thereupon their only function is to pay it to the stockholders."

So in Machen on Modern Law of Corporations, vol. 2, § 1358, that writer says:

"As a dividend when declared becomes a debt of the company, it follows that a dividend once properly declared, cannot be revoked."

Morawetz, in his book on Corporations, volume 1, § 445, says that:

"A dividend properly declared by the directors of a corporation cannot subsequently be revoked; those persons who were shareholders on the books of the company at the time when the dividend was declared

have a legal claim against the company for the payment of the amount of the dividend."

And in Marshall on Corporations, § 283, it is said:

"Since the right of the stockholders of a corporation to a dividend becomes vested as soon as the dividend has been fully declared by the directors, and the corporation becomes their debtor for their respective shares, it follows that neither the same board of directors nor their successors can afterwards reconsider their action and revoke the declaration without the stockholders' consent."

4. A difference seems to exist between a cash dividend and a stock dividend, so that, if a board of directors declare a stock dividend, the authorities appear to recognize the right of the board subsequently to rescind its action at any time prior to the actual issuance of the stock.

The leading case on the subject is that of Terry v. Eagle Lock Co., 47 Conn. 141, 1879. It appears in that case that at a meeting of stockholders of the defendant company held on August 5, 1875, it was voted to increase the capital stock 2,000 shares, and that the said increase be out of the surplus earnings of the company. It was at the same time voted that the directors be authorized and directed to cause the stock to be issued to the present stockholders pro rata. On August 18, 1875, a specially called stockholders' meeting was held, and a vote was passed rescinding the vote of August 5th increasing the capital stock. The plaintiff stockholder who had not been present at the meeting at which the former vote was rescinded asked to have his pro rata share of the increase issued to him, or the value thereof paid to him, claiming that by the first vote he had a vested right of which he could not be deprived by the subsequent rescission. The court, in referring to the alternative prayer in the plaintiff's petition asking for a proportionate part of the supposed increase of stock or the cash value of his proportion of the increase, declared it very clear that the alternative prayer ought not to be granted, as it would in effect be making it a cash dividend, something "the company never intended. It would withdraw from the working funds of the company that amount which would not have been the result had the stock dividend been carried into effect. It is in effect asking the court to make a dividend instead of enforcing one made by the company." The Connecticut court denied, also, the stockholders' right to compel the company to issue the stock certificates, and it clearly pointed out the difference existing between a cash and a stock dividend. In the course of its opinion the court said:

"There is a difference, however, between a cash and a stock dividend. The former is created by a simple vote of the directors, and the amount thereby becomes severed from the general fund and belongs to the stockholders pro rata. The latter can be initiated only by a vote of the stockholders. That is followed by issuing the stock, and the increase can only be completed legally by filing with the town clerk and with the secretary of the state the certificates required by law. Suppose the vote had been to increase, not from the surplus earnings, but by a sale of the newly created stock. In such a case, it cannot be said that the capital is actually increased until the new stock is subscribed for at least. Until then there is an element of uncertainty about it. It

may never be taken. It is very clear that the vote to increase is not per se an increase. Nor is it such where the increase contemplated is from the surplus earnings.

"Again, a cash dividend entitles the stockholder to so much money, the ordinary way in which he receives from time to time the fruits of his investment. Such dividends do not materially affect the value of the stock. A stock dividend is exceptional. It does not add to his ready cash, but it changes the form of his investment by increasing his number of shares thereby diminishing the value of each share, leaving the aggregate value of all his stock substantially the same. It is of no special importance whether that value be divided into few or many shares.

"These differences are somewhat material, and serve to show that the petitioner's right, if he has such a right, to an increase of the number of his shares, was at the time a mere nominal right, and one which possessed no appreciable pecuniary value. It is at least doubtful whether a court of equity will in any case aid in enforcing such a right. But however this may be, there are other reasons of a pretty substantial character why the prayer of the petition should not be granted.

"The petitioner's right, as we have seen, was a mere naked right which he might waive without losing anything, and might enforce, if it could be enforced, without gaining anything. It became a mere question of expediency—shall the surplus be actually converted into capital, or remain surplus and be used as capital? The corporation chose the latter; and the petitioner, having nothing to gain or lose in either case, acquiesced in that decision."

In Dock v. Schlichter Jute Cordage Co., 167 Pa. 370, 379, 31 A. 656, 1895, a stock dividend was declared on July 16, 1890, and on March 16, 1891, it was rescinded. The court held that a resolution adopted by the directors of a corporation distributing among the shareholders shares of stock of the company which had been purchased by the company out of its earnings cannot be subsequently rescinded where it is not shown that such distribution would be injurious to the business of the company. It was said that if, upon the declaration of a dividend, the company deposited the moneys to pay the dividends with a banker and drew its check to the order of each entitled on the fund so deposited, or in the case of a stock dividend if the company executed its power of attorney to transfer the shares and these awaited delivery, the stockholders' right would be a vested one which could not be taken from him by a rescinding vote of the directors. Then followed this statement:

"It is believed that, when there has been no such appropriation as that above mentioned, a company by its board of directors in a proper case and for cause may rescind a resolution declaring a dividend; as where owing to destruction of a plant by fire immediately following such resolution. If in the business and honest judgment of the board the earnings intended to be distributed should be recalled and used for the restoration of the destroyed property, it would be within its power to so deal with them; but, unless some similar thing appear, the declaration of a dividend of earnings is the announcement of an obligation due each shareholder for which proceedings may be had as legal meth-

ods indicate, and the burden of manifesting that the debt or obligation is not due after such a declaration is upon the company."

In the above case the court wrote no opinion, but affirmed "on the clear, concise and convincing report of the master."

In Billingham v. E. P. Gleason Mfg. Co., 101 App.Div. 476, 91 N.Y.S. 1046, the directors passed a resolution providing for a regular cash dividend and for a scrip dividend. The scrip certificates were issued, and the court held that they constituted an indebtedness. An action was brought on one of them against the company, and the court held the action maintainable, and in speaking of the certificates the court said:

"It was so much set apart and reserved for him as undivided earnings. His share was ascertained and his right to it was fixed. It was a divided share of past earnings, and, as we think, became a severed indebtedness of the company, for nothing is better understood than that a dividend when declared is a debt due absolutely to the stockholders."

In the case at bar the scrip certificates were never issued.

In Machen on Modern Law of Corporations, vol. 1, § 601, the law is stated as follows:

"Rescission of Stock Dividends. A stock dividend should also be distinguished from a cash dividend, in that, in the case of cash dividend, the right of the shareholder becomes indefeasible immediately upon the declaration of the dividend, and the company cannot subsequently rescind its action. In the case of a stock dividend, on the other hand, until the formalities required by law as conditions precedent to an increase of capital have been completed, all is in fieri, so that until then the company may revoke the dividend. The reason of this rule applies, however, only where the stock dividend involves an increase of the company's nominal capital, and therefore a dividend payable in shares which had been purchased by the company should be in this respect assimilated to a cash dividend and is irrevocable."

It is undoubtedly true that directors may repeal any previous resolution or rescind any previous action unless repeal or rescission would involve a breach of contract or disturb a vested right. The resolution originally adopted by the directors certainly created no debt. The declaration was not to pay a cash dividend absolutely, for the directors had an option which they reserved as to whether they would or would not pay in cash. The distinguishing and necessary feature of a "debt" is that a fixed and specific amount is owing by a certain and express agreement, and that does not exist under the circumstances we find in this case. The directors did not bind themselves to pay a cash dividend absolutely, and in all events, and if they should ultimately elect to pay in cash, they were left free to determine how much should be in cash and how much should be in stock. And as to the declaration as to the stock dividend it should be said that the whole matter rested in fieri, and, not having become obligatory, was subject to repeal. * * *

Decree affirmed.[6]

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[6] On the revocability of declared dividends, see Notes, 1916, 16 Col.L.Rev. 599; 1917, 15 Mich.L.Rev. 432; 1930, 28 Mich.L.Rev. 914; 1917, 26 Yale L.J. 598. See Note, 1930, 39 Yale L.J. 1163, 1166–1172, on the revocability of a stock dividend.

In Re ASSOCIATED GAS & ELECTRIC COMPANY. CLARKE v. NEW YORK TRUST COMPANY et al.

Circuit Court of Appeals of the United States, Second Circuit, 1943.
137 F.2d 607.

Proceedings in the matter of the reorganization of the Associated Gas & Electric Company, debtor, under § 101 et seq. of the Bankruptcy Act, 11 U.S.C.A. § 501 et seq. On petition of Stanley Clarke, trustee of the debtor, for determination of status of certain funds claimed by him to be general assets of debtor's estate, opposed by New York Trust Company, as trustee, and others. From parts of an order holding funds to be trust funds for special classes of creditors, debtor's trustee appeals.

Order modified.

SWAN, CIRCUIT JUDGE. Associated Gas and Electric Company, hereafter called the Company, filed a voluntary petition for reorganization on January 10, 1940. On that date there existed undisbursed balances of funds which the Company had previously transmitted to Transfer and Paying Agency (called Trapa), Irving Trust Company and Chase National Bank, respectively, to be used to pay obligations of the Company maturing before January 10, 1940. The trustee in reorganization claims these balances as general assets of the company's estate and has appealed from portions of an order of the district court holding them to be trust funds for the benefit of the holders of matured but uncollected securities, interest coupons and checks payable before January 10, 1940. * * *

The third fund involved in this appeal is a balance of $17,910.17 in an account in the Chase National Bank entitled "Associated Gas and Electric Company, Dividend Account No. 1." No claimant, other than the trustee in reorganization, to any part of this fund appeared in the district court or in this court. This is readily understandable when it is noted that the number of checks outstanding against the account is 5,175, of which only 111 call for $25 or more; these 111 checks total $5,689.56. The account was opened in April 1927. Checks drawn upon it were signed by the Company's officers. It was the Company's practice at times to withdraw from the account an amount representing uncashed checks outstanding for six months or more and to deposit such withdrawals in the Company's general bank account. When old checks were later presented, sums were deposited to replenish the account to that extent. Millions of dollars passed through the account but by August 1932 it had become inactive and had a balance of less than $400. On October 31, 1934, while an involuntary 77B proceeding, 11 U.S.C.A. § 207, was pending, the Company deposited in the account the sum of $21,157.03, which was the balance shown by its books in the "Reserve for unpaid dividend and interest checks." Later, in March 1935, a list of outstanding unpaid checks was prepared and the balance in the account was adjusted to equal the total of such list, namely, $21,334.17. The list proved not to be complete; unlisted checks were presented from time to time and were paid from the ac-

count. The district court's opinion states that practically all the money in the account represents outstanding checks for dividends on capital stock, either of the Company or its subsidiaries. By a supplemental finding the court found that some of the outstanding checks on the account are for interest while others are for dividends and that the proportion of the deposits and of the outstanding checks that is for interest and the proportion that is for dividends is unknown.

Where a corporation has not only declared a dividend but has specifically set apart from its other assets a fund out of which the dividend is to be paid, such fund is held in trust for stockholders entitled to the dividend. In re Interborough Consol. Corporation, 2 Cir., 288 F. 334, 341, certiorari denied sub nom. Porges v. Sheffield, 262 U.S. 752, 43 S.Ct. 700, 67 L.Ed. 1215; Staats v. Biograph Co., 2 Cir., 236 F. 454, 458, L.R.A.1917B, 728; In re Interborough Consol. Corporation, D.C.S.D.N.Y., 267 F. 914, 919. While the question is not free from doubt, we believe that the October 1934 deposit falls within this rule to the extent that dividend checks may be presented for payment out of the fund, notwithstanding the intermingling of interest and dividend checks in determining the amount of the deposit. Affirmance of the order in this respect will doubtless have little significance in actual dollars since holders of the checks are by the terms of the order to be barred unless their claims are presented by a date to be fixed by further order of the court, and such portion of the $17,910.17 as is not paid on dividend checks will become general assets of the Company.

The cause is remanded for modification of the order in conformity with this opinion.

MEYERS v. EL TEJON OIL & REFINING COMPANY.

Supreme Court of California, 1946. 174 P.2d 1.

Action by Walter J. Meyers against El Tejon Oil and Refining Company on a promissory note. From a judgment for plaintiff, the defendant appeals.

Judgment affirmed.

TRAYNOR, JUSTICE. On March 15, 1940, a dividend was declared upon defendant's common stock at a special meeting of defendant's board of directors attended by only four of its seven directors. No notice of the meeting was given to the directors as required by section 307a of the Civil Code, nor did the absent directors sign a waiver of notice or a consent to the meeting or an approval of its minutes as required by section 307b of the Civil Code. Plaintiff who was then vice-president of the corporation as well as one of its directors was present at the meeting. The dividend was paid in cash to all holders of common stock, but the seven directors who were also holders of such stock, immediately returned their dividends to the corporation and received in exchange promissory notes in amounts equal to their respective dividends. Only one of the seven notes has been paid. The present action was brought on April 14, 1944, to recover upon the one given plaintiff. The trial court found "that any irregularity in the declaration of

the dividend of March 15, 1940, has been ratified and confirmed by [defendant] corporation" and entered judgment for plaintiff. Defendant appeals.

Defendant contends that since the authority to declare a dividend is vested in the board of directors (Civ.Code, §§ 305, 363) and since the directors can pass a valid resolution only if the board is duly assembled for the purpose of transacting corporate business (Civ.Code, § 307; Pauly v. Pauly, 107 Cal. 8, 18, 40 P. 29, 48 Am.St.Rep. 98; Hotaling v. Hotaling, 193 Cal. 368, 377, 224 P. 455, 56 A.L.R. 734; Curtin v. Salmon River, etc., Co., 130 Cal. 345, 350, 62 P. 552, 80 Am.St.Rep. 132; see 6A Cal.Jur. 1097), the declaration of the dividend was invalid, and that therefore the corporation issued the note to plaintiff without consideration. A resolution of the board of directors declaring a dividend, even though it is unlawful in its inception for lack of a duly held meeting, can be ratified by the board of directors, and such ratification does not require the holding of a regular meeting of the board or the passing of a resolution declaring the ratification. Brown v. Crown Gold Milling Co., 150 Cal. 376, 387, 89 P. 86; Scott v. Superior Sunset Oil Co., 144 Cal. 140, 143, 77 P. 817; Hibernia Sav. & Loan Soc. v. Belcher, 4 Cal.2d 268, 276, 48 P.2d 681; see 6A Cal.Jur. 1181; 19 C.J.S., Corporations, §§ 1018-1024, pp. 495-507; 11 Fletcher, Corporation, § 5351. "Anything from which it may be clearly found * * * that the board as a board had agreed that the void act should be binding will suffice." Milligan v. G. D. Milligan Grocer Co., 207 Mo.App. 472, 233 S.W. 506, 510. Thus, in Hibernia Savings & Loan Soc. v. Belcher, 4 Cal.2d 268, 275, 48 P.2d 681, it was held that if authority to make the assignment there involved was vested only in the board of directors, the subsequent acquiescence of an absent director in the assignment made at a special meeting attended by only two of the three directors of the corporation constituted an implied ratification of the assignment. In the present case the record discloses that each director returned the cash payment and accepted in exchange a note similar to the one given plaintiff; that all of these notes were carried as notes payable upon subsequent financial statements of the corporation; and that one of them has since been paid. This evidence supports the finding of the trial court that the irregularity of the resolution declaring the dividend was cured by subsequent ratification of the dividend. In Milligan v. G. D. Milligan Grocer Co., supra, a dividend declared at an invalid meeting of the board of directors was held to be ratified under similar circumstances. The court stated that "the fact that the dividend was credited on the books of the corporation to the individual stockholders immediately after it was purported to be declared, and had been permitted to so remain for about 18 months before this suit was brought, and that in the meantime at least one regular meeting of the board was held and no order made of record disaffirming * * the dividend, * * * is sufficient to [support] a finding [of ratification]." 233 S.W. at page 510. Since a ratification has retroactive effect (see 19 C.J.S., Corporations, § 1023, p. 505) the dividend must be regarded as authorized by the board of directors as of the time when it was declared, and thus, plaintiff did not acquire the note without consideration.

Defendant applied for the admission of additional evidence under section 956a of the Code of Civil Procedure that since the issuance of the note in 1940, defendant defaulted on the payment on dividends on its preferred stock, that the last dividend on that stock was paid in January, 1942, and that therefore the corporation by paying the note would violate its articles of incorporation, which provide that the dividends on the preferred stock are cumulative and payable before any dividends on the common stock are paid. It is immaterial, however, whether the corporation became delinquent on its preferred stock years after the dividend on the common stock was declared. Each holder of common stock acquired a vested right to the payment of the dividend, which cannot be defeated by later revocation of the dividend without his consent. Smith v. Taecker, 133 Cal.App. 351, 352, 24 P.2d 182; see Ballantine, Private Corporations, 502, 504, and cases there cited. Under these circumstances it is unnecessary to determine whether the taking of additional evidence would otherwise be proper.

Defendant also contends that the dividend was not declared out of surplus or net profits as required by section 346 of the Civil Code. Defendant's answer to the complaint did not raise this issue, and at the trial defendant limited its defense to the issue that the dividend was declared at a meeting of the board of directors that was not properly held. When the trial judge stated at the trial: "I have looked over the answer. The only defense seems to be that it was a dividend that was not properly declared," counsel for defendant declared, "Our defense is that there was no legal meeting at which the dividend was declared." The issue whether defendant had sufficient surplus or net profits to declare a dividend is entirely different from the issue whether the board of directors had properly authorized the dividend, and cannot first be raised on appeal. Even in a complaint of a shareholder seeking the payment of a dividend declared by the corporation the plaintiff need not allege that the corporation had the necessary surplus or profits. Any issue as to the availability of the surplus or profit required for the declaration of a dividend must be raised by the corporation. See 11 Fletcher, Corporations, § 5365; Federal Mining & Smelting Co. v. Wittenberg, 15 Del.Ch. 409, 138 A. 347, 55 A.L.R. 8, 145; City Bank Farmers' Trust Co. v. Hewitt Realty Co., 257 N.Y. 62, 177 N.E. 309, 76 A.L.R. 885, 896; Bates v. Brooks, 222 Iowa 1128, 270 N.W. 867, 109 A.L.R. 1381, 1400; 13 Am.Jur. 736. Moreover, the testimony of defendant's secretary, on which defendant relies, to the effect that the payment of the dividend to the directors in cash "would have run our working capital a little short at that time" falls short of establishing that defendant lacked the required surplus or net profits. Furthermore, section 364 of the Civil Code, as it read when the dividend was paid to plaintiff and when he exchanged it for the note sued upon, provided that a corporation could recover an illegally paid dividend only if it had been declared insolvent or bankrupt. Since defendant could not recover the dividend that plaintiff exchanged for the note, the dividend was consideration for the note, even if it be assumed that the dividend was declared in violation of section 346.

The judgment is affirmed.

3. FUNDS FROM WHICH DIVIDENDS MAY BE PAID

(a) *Cash Dividends*

VERNER v. GENERAL & COMMERCIAL INVESTMENT TRUST.

Court of Appeal. [1894] 2 Ch. 239.

[The General & Commercial Investment Trust, a limited company, was formed in 1888 to invest in securities;[7] the income from these investments to be paid out as dividends to the stockholders. At the end of the fiscal year 1894 the company's investments had declined by at least £250,000.

A director, on behalf of himself and other stockholders, brought suit against the company and its directors to restrain the declaration and payment of any dividend for the year ending February 28, 1894. Injunction denied, and plaintiff appeals.]

LINDLEY, L. J. The judgment I am about to deliver is the joint judgment of the Lord Justice A. L. Smith and myself.

The broad question raised by this appeal is, whether a limited company which has lost part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent; but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles. We, however, have only to consider the legality or illegality of what is complained of.

As was pointed out in Lee v. Neuchatel Asphalte Company, 41 Ch.D. 1, there are certain provisions in the Companies Acts relating to the capital of limited companies; but no provisions whatever as to the payment of dividends or the division of profits. Each company is left to make its own regulations as to such payment or division. The statutes do not even expressly and in plain language prohibit a payment of dividend out of capital. But the provisions as to capital, when carefully studied, are wholly inconsistent with the return of capital to the shareholders, whether in the shape of dividends or otherwise, except, of course, on a winding-up, and there can, in my opinion, be no doubt

7 "Essentially, investment companies are large, liquid pools of public savings entrusted to the company management for investment in productive enterprise. Normally they invest for the yield, including capital appreciation, and not for the control of productive wealth—a feature which distinguishes them from holding companies. Shareholders are induced to purchase investment company securities by the prospect of obtaining a diversification and expert management of their investments which, as individuals, they could not afford to command. Frequently the sales and promotional literature of these companies, by stressing the necessity of providing for old age and emergencies, has analogized them to banks and insurance companies, except that they are not limited to so-called 'legal' investments. In organization and practise they have assumed an almost infinite variety of forms." Note, The Investment Company Act of 1940, 1941, 50 Yale L.J. 440, 440–441.

that even if a memorandum of association contained a provision for paying dividends out of capital such provision would be invalid. The fact is that the main condition of limited liability is that the capital of a limited company shall be applied for the purposes for which the company is formed, and that to return the capital to the shareholders either in the shape of dividend or otherwise is not such a purpose as the Legislature contemplated.

But there is a vast difference between paying dividends out of capital and paying dividends out of other money belonging to the company, and which is not part of the capital mentioned in the company's memorandum of association. The capital of a company is intended for use in some trade or business, and is necessarily exposed to risk of loss. As explained in Lee v. Neuchatel Asphalte Company, the capital even of a limited company is not a debt owing by it to its shareholders, and if the capital is lost, the company is under no legal obligation either to make it good, or, on that ground only, to wind up its affairs. If, therefore, the company has any assets which are not its capital within the meaning of the Companies Acts, there is no law which prohibits the division of such assets amongst the shareholders. Further, it was decided in that case, and, in my opinion, rightly decided, that a limited company formed to purchase and work a wasting property, such as a leasehold quarry, might lawfully declare and pay dividends out of the money produced by working such wasting property without setting aside part of that money to keep the capital up to its original amount.

There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it, without preserving the capital sunk so as to be able to reproduce it intact either before or after the winding-up of the company.

A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value. But in the absence of some special article or contract, there is no law to this effect; and, in my opinion, for very good reasons. It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company, either not in debt or well able to pay its debts, from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. Even a sinking fund to replace lost capital by degrees is not required by law.

It is obvious that dividends cannot be paid out of capital which is lost; they can only be paid out of money which exists and can be divided. Moreover, when it is said, and said truly, that dividends are not to be paid out of capital, the word "capital" means the money subscribed pursuant to the memorandum of association, or what is represented by that money. Accretions to that capital may be realized and turned into money, which may be divided amongst the shareholders, as was decided in Lubbock v. British Bank of South America, [1892] 2 Ch. 198.

But, although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company's assets, it does not follow that dividends may be lawfully paid out of other assets regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape, and to divide as dividend the receipts, say, for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eyes of business men. The same observation applies to payment of dividends out of borrowed money. Further, if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital consumed in producing it will be a payment of a dividend out of capital within the meaning of the prohibition which I have endeavoured to explain.

It has been already said that dividends presuppose profits of some sort, and this is unquestionably true. But the word "profits" is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends cannot be paid out of capital, than by saying that they can only be paid out of profits. The last expression leads to the inference that the capital must always be kept up and be represented by assets which, if sold, would produce it; and this is more than is required by law. Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law.

The Companies Acts do not require even limited companies to keep accounts, still less to keep them in any particular form. The only enactment on the subject is sect. 26 of the Companies Act, 1862, and Form E in the second schedule, and these relate solely to the nominal capital and calls. But, although this is so, yet, as a matter of business, accounts of some sort must be kept; and in order to shew the money so subscribed, and to shew the results of the company's trading or business, it is practically necessary to keep a capital account and what is called a profit and loss account, and as a matter of business these accounts ought to be kept as business men usually keep them. Accordingly, we find provisions for keeping such accounts in Table A in the Appendix to the Companies Act, 1862 (see articles 78-82), and in the articles of association of most, if not all, companies. But there is no law which compels limited companies in all cases to recoup losses shewn by the capital account out of the receipts shewn in the profit and loss account, although care must be taken not to treat capital as if it were profit. This is in accordance with Bolton v. Natal Land and Colonization Company, [1892] 2 Ch. 124, which is the latest reported case on the subject. Further, it is obvious that capital lost must not

appear in the accounts as still existing intact. The accounts must shew the truth, and not be misleading or fraudulent.

The Acts of 1867 and of 1877 are in no way inconsistent with these observations. They provide for the reduction of the nominal capital mentioned in the memorandum of association. They do not render it obligatory on a company which has lost some of its capital to reduce the nominal amount mentioned in its memorandum. There are advantages in doing so, and the Acts were passed to enable limited companies to obtain these advantages, but there is nothing in these Acts, any more than in the Act of 1862, which prevents a company which has lost part of its capital from continuing to carry on business and declaring and paying dividends. A law forbidding this may well have been considered by the Legislature far too rigid, and in their desire to check dishonest and reckless trading Courts must be careful not to put tighter fetters on companies than the Legislature has authorized.

It follows from what has been said above that the proposed payment of dividend in this particular case cannot be restrained. Mr. Justice Stirling has, in his judgment, examined the memorandum and articles of association so fully that I do not think it necessary to examine them again. It is plain there is nothing in them which requires lost capital to be made good before dividends can be declared: on the contrary, they are so framed as to authorize the sinking of capital in the purchase of speculative stocks, funds, and securities, and the payment of dividends out of whatever interest, dividends, or other income such stocks, funds, and securities yield, although some of them are hopelessly bad, and the capital sunk in obtaining them is lost beyond recovery: (see the memorandum of association (i) and articles 84 and 85). There is no suggestion of any improper juggling with the accounts, and there is no payment of dividend out of capital. There is no insolvency, and we have not to deal with a petition to wind up. Some capital is lost, but that is all that can be truly said, and that is not enough to justify such an injunction as is sought. The appeal must be dismissed with costs.

KAY, L. J.: I should be sorry if it were held that a joint stock trading company can properly estimate their profits in any way differing from that in which an individual or a partnership of individuals carrying on a similar business would do.

An ordinary trader takes a yearly account of all the capital employed in his business, allows for any loss or depreciation in value, and carries the balance to the profit and loss account from which he makes out the profit or loss of the year. In this mode a loss or depreciation of such capital affects directly the profit of the year, which is thereby diminished. But, if upon the whole capital account there is a gain, this goes to swell the year's profits.

In my opinion a joint stock trading company should do the same. The question in this case is whether the capital employed by this company in making investments is capital employed in the business for the purpose of this usual mode of taking the year's account.

If the company were formed for the purpose of buying stocks, shares, and the like to sell again, and their business was to make profit

on such resale, it is obvious that any profit or loss on such transactions must be estimated in the way I have stated. But this is not their business. They buy stocks, shares, and the like, and they have power to sell and change them. But they buy as investments, and do not look to the sale as the source of their profit. They buy, we are told, all sorts of investments which nominally pay a large rate of interest—those, in short, in which a prudent man would not invest his own money, and the source of their profit is that having very large funds intrusted to them by the confiding public, they are able out of the income of these investments to pay in most years something more to their shareholders than the 3 or 4 per cent. which represents at present the utmost income that can be obtained from safe securities. The natural result of such a reckless dealing with the moneys intrusted to them has followed in this case. There has been an actual loss of invested capital to the amount of about £75,000. If the depreciation below the cost price of other investments be added to this, the loss is much greater. This company seems to have been courting the fate which has overtaken other similar companies which are now in liquidation. The company have power by their articles to form out of income a reserve fund before declaring any dividends, and if they were to do this in order to make good the loss they have sustained, the directors would be acting within their powers; so, if the capital had been increased by a rise in value of the investments, I conceive that they might have realized some part of that increase, and distributed it as dividend. The question is whether they were compellable to do either of these things.

It is argued that in the events that have happened, if they do not replace the lost capital out of income, they will in effect be paying dividends out of capital. This is only another mode of trying the same question. If they are not bound so to replace the lost capital, they may divide the whole income among the shareholders without devoting any of it to this purpose. I have not a very confident opinion in the matter, but on the whole I am not satisfied that there is any legal obligation on the directors to do this. The persons who have been so foolish as to take shares in this company seem to me, with their eyes open, to have entered upon a reckless and dangerous speculation, involving an almost certain loss and depreciation of capital. They seem to me to have authorized their trustees to make the investments which they have made. In the case of any ordinary trust it is not the right of any cestui que trust, where an authorized investment has failed, to require that it should be replaced out of the income of the remaining investments. That would be sacrificing the interest of a tenant for life to that of the remaindermen. In this company the effect would be to give the deferred shareholders a benefit out of the income of the preference shareholders. I do not think this was the intention. [His Lordship here read clause 3(i) of the memorandum of association, and clauses 84 and 85 of the article, and proceeded:—]

These provisions seem to me to mean that any income received may be divided, whether part of the capital is lost or not. At present I do not know of any law to prevent this, and it might be difficult to

frame such a law without unduly interfering with the liberty of commercial proceedings. I have no sympathy whatever with those who have become shareholders in such an undertaking. The objects and the effect of the operations of such companies is to give a fictitious value to other speculations as unsound as their own, by keeping up the market price of the stocks and shares in which it is their business to invest, and the sooner it is generally understood what the probable result of such transactions may be, the better it will be for the commercial and investing classes in general.[8]

RANDALL v. BAILEY et al.

Supreme Court of New York, 1940. 23 N.Y.S.2d 173.

Action by C. Walter Randall, as trustee of the Bush Terminal Company, debtor, against Frank Bailey and others to recover on behalf of the debtor the amount of dividends declared and paid by defendants, former directors of the debtor. Defendants filed motions for judgment at the close of the whole case.

WALTER, JUSTICE. A trustee of Bush Terminal Company, appointed in a proceeding under Section 77B of the Bankruptcy Act, 11 U.S.C.A. § 207, here sues former directors of that company to recover on its behalf the amount of dividends declared and paid between November 22, 1928, and May 2, 1932, aggregating $3,639,058.06. At the times of the declarations and payments, the company's books concededly showed a surplus which ranged from not less than $4,378,554.83 on December 31, 1927, down to not less than $2,199,486.77 on April 30, 1932. The plaintiff claims, however, that in fact there was no surplus, that the capital was actually impaired to an amount greater than the amount of the dividends, and that the directors consequently are personally liable to the corporation for the amount thereof under Section 58 of the Stock Corporation Law. Defendants claim that there was no impairment of capital and that the surplus was actually greater than the amount which plaintiff concedes as the amount shown by the books.

The claims of the plaintiff, although branching out to a multitude of items, are basically reducible to four:

1. It was improper to "write-up" the land values above cost and thereby take unrealized appreciation into account.
2. It was improper not to "write-down" to actual value the cost of investments in and advances to subsidiaries and thereby fail to take unrealized depreciation into account.
3. It was improper to include as an asset an item of so-called good will, which the company carried at $3,000,000.
4. It was improper to include as an asset $492,958.30, being the cost of properties which had been demolished.

I discuss first the item of good will.

[8] Hatfield, Accounting, 1932, 268–269; Weiner and Bonbright, Anglo American Dividend Law: Surplus and Profits, 1930, 30 Col.L.Rev. 330, 343, 954, 966; Weiner, Book Review, 1927, 27 Col.L.Rev. 625, 626.

On March 6, 1902, shortly after its organization, the Bush Terminal Company entered into a contract with Irving T. Bush, who owned or controlled Bush Company, Ltd., which was then conducting a terminal enterprise in Brooklyn, and either under that contract or some arrangement constituting in effect a modification of it or a waiver of strict performance thereof, Bush Terminal Company issued $2,000,000 face amount of bonds and $3,000,000 par value of stock and received in addition to certain services of Irving T. Bush a large tract of land nearly contiguous to that owned by Bush Company, Ltd., and equipped with piers and warehouses, and other terminal facilities, and a lease by Bush Company, Ltd., of two of the piers. The $3,000,000 of stock was not entered upon the books of the company until December, 1905, and then under the same date, there was entered on the asset side of the ledger an item of good will in the same amount. It does not appear that that was done pursuant to any formal action of the board of directors fixing $3,000,000 as the value of any good will, but it does appear that the directors did in fact sanction the fixing of that value on such item.

Plaintiff stresses the fact that the company itself received the proceeds of the $2,000,000 of bonds and itself expended such proceeds in acquiring the land and erecting the piers and warehouses and other terminal facilities, and contends that it necessarily follows that the only possible asset which the company can be regarded as having received for the $3,000,000 of stock is the services of Mr. Bush for about two or three years. I think that is too narrow a view. Bush Company, Ltd., was an existing company which unquestionably had a good will of some value. Mr. Bush controlled that company. He also had an option to purchase the nearly contiguous land abovementioned. In 1904 Bush Terminal Company acquired the assets of Bush Company, Ltd. The result thus was that between the time of its organization in 1902 and the end of 1905 there had been assembled under the single ownership of Bush Terminal Company the existing plant and business of Bush Company, Ltd., and nearly contiguous land which Mr. Bush had permitted it to acquire at the price at which he had it under option, and additional piers and warehouses and other terminal facilities, and the whole thereof, at least so far as appears were being profitably operated. Such profitable operation then continued for a long period of years, and consecutively, year in and year out, for a period of over twenty years the item of $3,000,000 for good will was set forth upon the company's balance sheets and reported to stockholders with the approval of successive boards of directors.

Directors obviously cannot create assets by fiat, and I do not go so far as to say that, even as against the company and in favor of directors, assets can be created by laches, acquiescence, or estoppel, but whatever may now be thought of the wisdom or business judgment displayed in valuing at $3,000,000 in 1905 what the company received for the $3,000,000 of stock, I do not think that anything has been shown respecting the history of the company from its organization in 1902 to November 22, 1928, or to May 2, 1932, which warrants a finding that during the period here in question, 1928 to 1932, there

did not inhere in the assembled and established plant and facilities and going business an element of value in addition to physical assets which the directors were justified in valuing at $3,000,000.

The term "good will" is generally used as indicating that element of value which inheres in the fixed and favorable consideration of customers arising from an established and well-known and well-conducted business, and in an enterprise of this sort, enjoying no legal monopoly, and not a public utility in a legal sense, that element of value indisputably is property for which stock may be issued, and in the absence of fraud the judgment of the directors as to its value is controlling. Washburn v. National Wall-Paper Co., 2 Cir., 81 F. 17; Thoms v. Sutherland, 3 Cir., 52 F.2d 592, 597; White, Corbin & Co. v. Jones, 79 App.Div. 373, 79 N.Y.S. 583; Brown v. Weeks, 195 Mich. 27, 38, 39, 161 N.W. 945; Stock Corporation Law, § 69; and see Des Moines Gas Co. v. City of Des Moines, 238 U.S. 153, 164, 165, 35 S.Ct. 811, 59 L.Ed. 1244. It also is recognized that, apart from good will in that sense, there is what in the public utility rate cases is called "going concern value", by which is meant that element of value which inheres in an assembled and established plant, doing business and earning money, over one not thus advanced, and such element of value is treated as property which must be considered in determining the base upon which the utility is entitled to earn a return (Des Moines Gas Co. v. City of Des Moines, supra; Los Angeles Gas & Electric Corp. v. Railroad Commission of California, 289 U.S. 287, 313, 53 S.Ct. 637, 77 L.Ed. 1180), and I can perceive no reason why such "going concern value" should not be recognized here as well as in a utility rate case. It is merely a recognition of the fact that there is a "difference between a dead plant and a live one" (City of Omaha v. Omaha Water Co., 218 U.S. 180, 202, 30 S.Ct. 615, 620, 54 L.Ed. 991, 48 L.R.A.,N.S., 1084), or between a "living organism" and "bare bones" (Los Angeles Gas & Electric Corp. v. Railroad Commission of California, 289 U.S. 287, 314, 53 S.Ct. 637, 77 L.Ed. 1180), and the evidence abundantly establishes that what happened here was that an unused waterfront and adjoining uplands aggregating over 200 acres were assembled and converted into a great terminal, with piers, warehouses, lofts, railroads, and other shipping and transportation facilities, to which both industry and shipping were attracted as a result of diligent and in some instances ingenious efforts, and which enjoyed an international reputation for the excellence of the services rendered through assembled facilities and a trained personnel. I consequently hold this item allowable.

I next turn to the subject of unrealized appreciation and depreciation.

Until 1915 the company's land was carried upon its books at cost. In 1915 the land was written up to 80% of the amount at which it was then assessed for taxation, and in 1918 it was written up to the exact amount at which it was then so assessed. Those two write-ups totalled $7,211,791.72, and the result was that during the period here in question the land was carried on the books at $8,737,949.02, whereas its actual cost was $1,526,157.30. Plaintiff claims that the entire $7,211,-

791.72 should be eliminated because it represents merely unrealized appreciation, and dividends cannot be declared or paid on the basis of mere unrealized appreciation in fixed assets irrespective of how sound the estimate thereof may be. That obviously and concededly is another way of saying that for dividend purposes fixed assets must be computed at cost, not value, and plaintiff here plants himself upon that position, even to the point of contending that evidence of value is immaterial and not admissible. If that contention be sound, the company indisputably had a deficit at all the times here involved in an amount exceeding the dividends here in question. The importance of the question so presented, both to this case and to corporations and corporate directors in general, is thus apparent, and it is, I think, surprising that upon a question so important to and so often occurring in the realm of business there is, not only no decision which can be said to be directly in point, but, also, no discussion in text-book or law magazine which does much more than pose the question without answering it. * * *

The question I have to decide is whether or not an existing statute has been violated. The problem is one of statutory construction. * * *

I hence prefer to base my decison upon the assumption that the controlling words of the statute are merely these: "No stock corporation shall declare or pay any dividend which shall impair its capital or capital stock, nor while its capital or capital stock is impaired."

Before one can determine whether or not capital or capital stock has been impaired, one must determine what is capital or capital stock. The words to be construed thus are words which have varied and different meanings and express radically different concepts in different connections. Capital means one thing to an economist, or perhaps more accurately, different things to different economists, and it has still different meanings to accountants and to business men. It even means different things in different statutes. To determine its meaning in this statute it thus is essential, I think, to consider the history of the statute and what our courts have said respecting the statute's predecessors. (This paragraph of the opinion is omitted.)

It thus appears that after using the surplus and surplus profits terminology for practically a hundred years the legislature completely abandoned it, and I think that is quite significant as indicating a conscious intent to get away from the idea of profits earned as a result of completed transactions as the sole source of dividends. I do not say that the legislature thereby changed the existing law. On the contrary, I think that the terms capital and capital stock as used in the earlier statutes had been construed by the courts in such a way that the terms surplus and surplus profits as used therein necessarily meant any accretion or accumulation over and above debts and the liability to stockholders, and that the legislature of 1923 recognized and adopted that construction and omitted any reference to surplus or surplus profits for the very reason that by some persons those words were believed to convey the idea of and to be confined to an accumulation of net earnings resulting from completed transactions and for the

express purpose of so clarifying the statute as to prevent the precise claim which plaintiff now here presses. * * *

Those statements by our highest court seem to me to make it entirely plain that the terms capital and capital stock in these statutes mean an amount, i. e. a value, of property up to the limit of the number of dollars specified as the par value of paid-up issued shares (or as the stated value of no-par shares), and that when the amount, i. e. the value, of the company's property exceeds that number of dollars the excess, whether "contributed by the stockholders or otherwise obtained" is surplus or surplus profits and may be distributed as dividends until the point is reached where such dividends "deplete the assets," i. e. the value of the assets, "below the sum," i. e. below the number of dollars, specified as the par or stated value of the paid-up issued shares. In other words, the capital or capital stock referred to in these statutes is the sum of the liability to stockholders, and any value which the corporation's property has in addition to that sum is surplus. And I cannot doubt that the words "otherwise obtained" and "accumulated," as used by the court in the cases just mentioned, include an appreciation in the value of property purchased whether realized or unrealized.

Additional support for this view is found, I think, in the fact that where corporations have made distributions to stockholders on the basis of appreciation in value such distributions have been held taxable as dividends paid. People ex rel. Wedgewood Realty Co. v. Lynch, 262 N.Y. 202, 186 N.E. 673; Id., 262 N.Y. 644, 188 N.E. 102; People ex rel. Mercantile Safe Deposit Co. v. Sohmer, 158 App.Div. 110, 143 N.Y.S. 313, affirmed 217 N.Y. 605, 111 N.E. 1097. * * *

In summary, I think that it cannot be said that there is a single case in this State which actually decides that unrealized appreciation cannot be taken into consideration, or, stated in different words, that cost and not value must be used in determining whether or not there exists a surplus out of which dividends can be paid. I think, further, that such a holding would run directly counter to the meaning of the terms capital and capital stock as fixed by decisions of the Court of Appeals construing the earlier statutes, and that such construction of those terms must be deemed to have been adopted by the legislature in enacting the statute here involved. See Matter of Scheftel's Estate, 275 N.Y. 135, 141, 9 N.E.2d 809. I thus obviously cannot follow decisions to the contrary in other States or any contrary views of economists or accountants. If the policy of the law be bad it is for the legislature to change it.

Throughout the period in question the company carried upon its books as assets its investments in and advances to its subsidiaries at their face value, i. e. at the cost thereof, and despite his insistence that unrealized appreciation of one asset cannot be taken into consideration, the plaintiff yet insists that these investments and advances must be written down to the value thereof as shown by the books of the subsidiaries, even though the subsidiaries are still carrying on business, and, further, that those books shall be what he calls "property adjusted," so as to cause them to show the actual value of the stock

of and claims against those subsidiaries. He thus, as it seems to me, takes the inconsistent position that while unrealized appreciation cannot be considered, unrealized depreciation nevertheless must be. Defendants, also, take the equally inconsistent position that while unrealized appreciation must be considered, unrealized depreciation need not be. I am of the opinion that the same reasons which show that unrealized appreciation must be considered are equally cogent in showing that unrealized depreciation likewise must be considered. In other words, the test being whether or not the value of the assets exceeds the debts and the liability to stockholders, all assets must be taken at their actual value.

I see no cause for alarm over the fact that this view requires directors to make a determination of the value of the assets at each dividend declaration. On the contrary, I think, that is exactly what the law always has contemplated that directors should do. That does not mean that the books themselves necessarily must be altered by write-ups or write-downs at each dividend period, or that formal appraisals must be obtained from professional appraisers or even made by the directors themselves. That is obviously impossible in the case of corporations of any considerable size. But it is not impossible nor unfeasible for directors to consider whether the cost of assets continues over a long period of years to reflect their fair value, and the law does require that directors should really direct in the very important matter of really determining at each dividend declaration whether or not the value of the assets is such as to justify a dividend, rather than do what one director here testified that he did, viz. "accept the company's figures." The directors are the ones who should determine the figures by carefully considering values, and it was for the very purpose of compelling them to perform that duty that the statute imposes upon them a personal responsibility for declaring and paying dividends when the value of the assets is not sufficient to justify them. What directors must do is to exercise an informed judgment of their own, and the amount of information which they should obtain, and the sources from which they should obtain it, will of course depend upon the circumstances of each particular case. What is said in Bourne v. Bourne, 240 N.Y. 172, 148 N. E. 180, with respect to courts reviewing the discretion and judgment of directors was not said with reference to the legality of the declaration of a dividend, and, furthermore, the statements there made are predicated upon the assumption that directors realize that they are under a duty to exercise an informed judgment with respect to the assets of the company of which they are directors and have performed that duty. If directors have blindly or complacently accepted either cost or any other arbitrary figures as indicative of value, they have not exercised either discretion or judgment and no court is required to act as if they had. When directors have in fact exercised an informed judgment with respect to the value of the company's assets, the courts obviously will be exceedingly slow to override that judgment, and clear and convincing evidence will be required to justify a finding that such judgment was not in accordance

with the facts. In the last analysis, however, the issue, in any case in which it is claimed that dividends have been paid out of capital, is the value of the assets and the amount of the liabilities to creditors and stockholders at the times the dividends were declared and paid.

Upon the evidence in this case I find that the directors here did in fact exercise an informed judgment with respect to the value of the good will, the value of the land of the company, and the value of the improvements thereon, and also with respect to the value of the land and improvements thereon which were owned by the subsidiaries, Bush Terminal Buildings Company and Bush Terminal Railroad Company, and that they believed and determined that the good will was worth $3,000,000 and that such land and improvements were worth several millions of dollars more than the amounts at which they were carried on the books. At least one of the directors was thoroughly versed in real estate values by reason of long and extensive experience in buying and selling and in recommending mortgage loans on real estate and was personally and thoroughly familiar with the properties and business of all the companies just named, and of the development thereof, from the time of the organization of the company, and no one could criticise any other director for relying upon his knowledge and judgment as to the value thereof, or for basing a judgment thereon. His knowledge and judgment probably were as safe and sound a guide as any formal appraisal that could have been obtained. At least one other of the directors likewise had a thorough familiarity with these properties and business from the inception of their developments. * * *

In summary, therefore, after considering all the evidence, I find that at the times these dividends were declared and paid the value of the assets exceeded the total liabilities to creditors and stockholders by an amount in excess of the total dividends, and that there accordingly was no impairment of capital or capital stock.

The conclusion thus reached makes it unnecessary to consider the question whether directors not present when a dividend is declared may be held liable because of presence at a subsequent meeting at which the prior declaration may be said to have been ratified, or any of the other defenses pleaded by defendants.

Defendants' motions for judgment at the close of the whole case are granted, and I direct the entry of judgment for defendants, with separate bills of costs to those appearing by separate attorneys.

NOTE

The New York Court of Appeals affirmed the decision, 288 N.Y. 280, 43 N.E.2d 43 (1942) saying:

The Legislature having declared that dividends may be paid when there is no impairment of capital or capital stock caused thereby and when the value of the corporate assets remaining after the payment of such dividends is at least equal to the aggregate amount of its debts and liabilities including capital or capital stock as the case may be, Stock Corporation Law, § 58, in other words from its surplus, our

inquiry turns to the question whether surplus may consist of increases resulting from a revaluation of fixed assets. Surplus has been well defined as follows in Ewards v. Douglas, 269 U.S. 204, 214, 46 S.Ct. 85, 88, 70 L.Ed. 235, Brandeis J.: "The word 'surplus' is a term commonly employed in corporate finance and accounting to designate an account on corporate books. * * * The surplus account represents the net assets of a corporation in excess of all liabilities including its capital stock. This surplus may be 'paid-in surplus,' as where the stock is issued at a price above par; it may be 'earned surplus,' as where it was derived wholly from undistributed profits; or it may, among other things, represent the increase in valuation of land or other assets made upon a revaluation of the company's fixed property. See La Belle Iron Works v. United States, 256 U.S. 377, 385, 41 S.Ct. 528, 65 L.Ed. 998."

The decision below was correct and the judgment should be affirmed, with costs.

NOTE

Dividends From Paid-In Surplus

Paid-in surplus (now more usually called "Capital surplus") originally consisted of that amount of surplus occasioned by the sale of par value stock at a price above par. The excess of the price above the par value constituted a surplus in the balance sheet.

The possibilities of this item became apparent some years after the invention of non-par stock. Since there was no fixed capital value or par, the sale or issue price of the share of stock could be split into a capital amount and a surplus amount by agreement with the parties (quaere if this is true in New York). But why do it? The answer was that where a corporation had been financed by issuing preferred stock and also issuing common stock, and it desired to pay dividends on its preferred stock, there was almost always a period of organization within which time the corporation made no money. If all the consideration received for its stock was capital, it had no surplus and could not legally pay dividends. Consequently it was advisable to so arrange matters that part of the consideration received for stock was surplus payable as dividends to preferred shareholders, and this is the ordinary use of paid-in surplus. If preferred stock be considered as analogous to a bond or note, the resulting operation is much the same as though a part of the capital contributed by the common stock were used to pay interest on the corporation's bonds.

Surplus has other possibilities, however. The surplus may be carved out of the consideration received for preferred stock. If this is paid to the preferred stock as dividends, the preferred shareholder is merely getting his money back in driblets. But it may also be paid at the same time to common stock, and the preferred shareholder who thinks he has a preferred claim may actually be contributing his money to the payment of dividends to common stockholders who have either paid less or agreed to risk more.

At the moment capital surplus is exceedingly popular and frequently used. Certain students of the corporate problem feel that the system has inherent dangers as making it easy for a corporation to distribute its capital assets without standing the test of earnings; and as permitting the distribution of the contribution of one class of shareholders to other classes of shareholders in a manner not contemplated by the contributors of the paid-in surplus thus distributed.

Surplus requires further analysis: all such surplus is not alike. It may arise from segregation of a part of the original contributions of the shareholders of an

organization. Or it may arise from payments by incoming shareholders to equalize an earned surplus previously built up. Or it may arise on reorganization, a new corporation taking over an existing business, and carrying forward in the new structure a surplus earned by the old. Or it may arise from upward revaluation of assets, as in Randall v. Bailey, supra. Do the same rules apply to all of these types of capital surplus?[9]

Most corporate balance sheets include an itemization of surplus account, distinguishing between "earned" and "capital" surplus.

NATIONAL LOCK COMPANY v. HOGLAND et al.

Circuit Court of Appeals of the United States, Seventh Circuit, 1938. 101 F.2d 576.

Suit by the National Lock Company against Frank G. Hogland and others to recoup the amount of funds which were alleged to have been unlawfully withdrawn from the plaintiff's treasury and appropriated to the personal use of the named defendant. Decree for plaintiff, and defendants appeal.

Reversed, with directions, as to the trial court's statement of a conclusion of law and affirmed in all other respects.

TREANOR, CIRCUIT JUDGE. * * * The plaintiff corporation is organized under and pursuant to the laws of the state of Delaware and the defendants are citizens of the state of Illinois. The defendant Hogland was president of the plaintiff corporation, a member of the Board of Directors and a stockholder during the period of the alleged illegal withdrawals of the corporation's funds. The defendants Grenberg and Strandquist were members of the Board of Directors and stockholders of the plaintiff corporation during the same period. The remaining defendant-appellant, Gust Anderson, was a member of the Board of Directors for a portion of such period and was a stockholder for the entire period. Also Anderson was for the entire period trustee of a trust created by defendant Hogland, the trust fund consisting of Hogland's personal assets to be utilized for the payment of Hogland's personal debts. Certain of the alleged unlawful withdrawals were traced into the Hogland trust assets.

It is undisputed in this cause that funds of the plaintiff corporation were withdrawn from its treasury and transferred to defendant Hogland in the form of loans. These funds were withdrawn with the knowledge of, assent thereto, and under the authorization of all of the defendants who were members of the Board of Trustees of plaintiff corporation. All such transactions were carried on in the state of Illinois and were in violation of the Delaware Corporation Act under which the plaintiff corporation was organized, and of a resolution of the Board of Directors of plaintiff corporation.

The trial court held that Delaware law was applicable and that the conduct of the defendants in respect to the withdrawal of funds of plaintiff corporation constituted a violation of their legal duty to the cor-

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[9] See, Berle and Means, The Modern Corporation and Private Property, 1932, 162–172; Katz, Accounting Problems in Corporate Distributions, 1941, 89 U. of Pa. L.Rev. 764, 765–774; Mitchell, Capitalization of Corporations Issuing Shares without Par Value, 1925, 11 A.B.A.J. 377; Note, Declaration of Dividends from Paid-In Surplus, 1931, 31 Col.L.Rev. 844

poration. It is not contended by defendants that the trial court erred in holding that the Delaware law was applicable.

The alleged illegal withdrawals of funds for the benefit of Hogland commenced on the 2nd day of January 1929, and continued through the year 1932. Defendants admit that as a result of the advances made to Hogland the amount of $169,129 is due the plaintiff from Hogland.

The trial court by its finding and decree fixed the principal sum due from defendant Hogland in the amount of $470,273.41. In fixing the foregoing sum the court refused to allow as credits three contested items consisting of the following: (1) Bonus credited to Frank G. Hogland on July 17, 1929,—$15,000; (2) bonus credited to Frank G. Hogland December 30, 1929,—$200,000; (3) common stock dividends credited on the account of Frank G. Hogland December 31, 1930,—$65,622. * * *

The dividend of $65,622 for which defendants claim credit was authorized at a meeting of the Board of Directors on December 30, 1930. In respect to defendants' claim the trial court's conclusion of law was that the declaration of the dividend was "ultra vires of the corporation and was unlawfully charged to the surplus account contrary to the provisions of the previous resolution of the Board of Directors." The conclusion of law is based upon (1) a finding that the Board of Directors passed a resolution in 1924 which provided "that thereafter no dividends should be charged to the permanent surplus fund created by the said resolution," and (2) the finding that "no further resolution of the Board of Directors of the plaintiff corporation appears authorizing the charging of any further dividends to the permanent corporate surplus account. * * *"

The resolution referred to was adopted in 1924 and contained the following provision: "* * * balance of the surplus fund * * * (shall) be transferred to a permanent surplus fund for plant and plant equipment and as a safety fund and from which no dividend shall be paid." The fund thus created was to be augmented by one-third of the balance of annual net profits after deductions for payment of dividends on outstanding preferred capital stock.

The creation of the "permanent surplus fund" for the purposes enumerated was a question of policy entirely within the discretion of the Board of Directors and could have been nullified by formal action of the board at any time. The prohibition of payment of dividends from the "permanent surplus fund" was discretionary with the Board, and the Board was not bound forever to refrain from charging dividends to such fund. The board being under no legal duty to continue to build up the permanent surplus fund, or to refrain indefinitely from charging dividends to it, had the power to revoke either the augmentation provision or the prohibition against payment of dividends. Instead of striking out or amending the dividend provision, the Board merely declared a dividend and ordered it charged to the surplus fund. This action was contrary to the unrevoked previous resolution and to that extent was irregular. But such action was not void. A Board of Directors cannot increase or decrease corporate powers; and no action of a Board of Directors which the corporation has the power to

perform through its directors can be ultra vires of the corporation merely because the board previously has declared by resolution that such action will not be taken.

Assuming that the dividend validly could have been charged to the permanent surplus fund, if the Board of Directors first had nullified the prohibition of the resolution of 1924, we are of the opinion that the Board had the power to make it a valid charge on the "permanent surplus fund" without formally suspending or repealing the previous prohibition. The declaring of the dividend as a charge on the surplus fund was in law a suspension by the Board of Directors of the restriction which the Board previously had imposed upon its discretion.

Plaintiff's argument goes beyond the foregoing and necessarily implies that the Board of Directors was without power to declare a dividend as a charge upon the "permanent surplus fund" regardless of any previous suspension or revocation of the restriction by formal action of the Board. The plaintiff contends that the resolution of 1924 "dedicated to the capital of the corporation" the "permanent surplus fund"; and that "the surplus so dedicated immediately became vested as a part of the trust funds of appellee (plaintiff) to be maintained by appellee for the benefit of all those with whom it came in contact,—its creditors, its preferred stockholders and its common stockholders."

If the "permanent surplus fund" was impressed with the character ascribed to it by plaintiff it became in fact and in law corporate capital in the technical sense. But we cannot attach that consequence to the resolution of the Board of Directors. The resolution contains no express declaration of an intention to convert the "permanent surplus fund" into cash capital; no requirement that the surplus fund be transferred to capital account. On the contrary the "fund" is to continue "permanent surplus fund" and was carried in "earned surplus" account as a "liability". The annual statement at the close of the year 1929 shows $673,803.14 in the "earned surplus account". The resolution authorized the use of the surplus fund for investment in "plant and plant equipment"; but the "permanent surplus fund" was to be used also "as a safety fund". The resolution left to the Board's discretion the question of how much of the surplus fund should be invested in "plant and plant equipment" and how any balance should be utilized "as a safety fund". Plaintiff assumes that all the accumulated surplus fund was reflected partly in the fixed assets of the corporation and partly in a capital asset of patents and good will valued at some $894,000, as shown by the balance sheet for 1929. But the same balance sheet shows cash on hand in banks in the sum of $304,265.17, in addition to notes and accounts receivable in the sum of $543,829.79. In the absence of a showing that any definite portions of the "permanent surplus fund" had been invested in fixed or capital assets, there is no basis for plaintiff's assumption that none of the accumulated surplus was reflected in the cash or other liquid assets.

We are of the opinion that the resolution did not have the effect of converting the "permanent surplus" into corporate capital, but merely set it aside for use in the conduct of the business. Undoubtedly the general rule is that undistributed surplus, which has been retained for

use in the corporate business, and which has been invested in physical assets, can be withdrawn and distributed as dividends. This rule was followed by the Supreme Court of Delaware in the case of Bryan v. Aiken, 1913, 10 Del.Ch. 446, 86 A. 674, 45 L.R.A.,N.S., 477, the reason and holding of which not only are pertinent to our question, but also constitute authority, since plaintiff is a Delaware corporation and the validity of its dividends must be determined by the law of its domicile.

In Bryan v. Aiken, supra, a dividend partly in cash and partly in stock was declared out of accumulated surplus which had been invested for a period of twelve years in "property or corpus" of the corporation in the form of permanent physical assets for use in the business of the corporation. The specific question decided was that a stock dividend declared out of such surplus belonged to a tenant for life; but the reasoning is applicable to our question. The Delaware Court's basic assumption is that undistributed surplus does not lose its character of corporate income, or earnings, merely by reason of its having been converted into corporate "property or corpus" in the form of physical assets which are permanently devoted to the business operations of the corporation.[10] And in the opinion of the Delaware Court a dividend "in cash, in stock, or in both, based upon such earnings" is a "distribution of profits", a "turning back to the stockholders" of "net earnings which had been temporarily used for improvements." [pages 679, 684].

Plaintiff cites Bryan v. Aiken, supra, as authority for the proposition that a "company had the right to withhold the earnings, and to permanently capitalize them if it deemed it necessary or proper in the conduct of its business to do so." But, as stated above, the Delaware Supreme Court held that investing surplus funds in permanent physical assets and treating them, for all practical purposes, as capital assets during a period of twelve years did not capitalize them nor destroy their availability for dividends as undivided profits.

In our opinion, under the authority of Bryan v. Aiken, supra, the "permanent surplus fund" of the instant case, whether invested in permanent physical assets of the corporation or retained in the form of cash or securities, continued to be undivided profits and available as the basis of dividends. We conclude that the trial court erred in stating its conclusion of law that the declaration of the dividend was "ultra vires of the corporation and unlawfully charged to the surplus account contrary to the previous resolution of the Board of Directors."

It follows that the defendant Hogland was entitled to credit for the amount of the dividend as of the date it was credited to his account. * * *

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10 "It may be regarded as settled law, we think, that although a corporation has the right to set apart or reserve a portion of its net earnings for a period of years, and treat them as capital, retaining them in its treasury, or expending them in the purchase of securities or real estate for the company, yet if it subsequently divides such net earnings among the stockholders by declaring a dividend in cash, in stock, or in both, based upon such earnings, it is a distribution of profits. * * * In such case the accumulated income, as well as the securities and real estate purchased, are all assets of the corporation, but the earnings are not regarded as capital although they may have been treated by the corporation as such prior to the distribution."

Our conclusion is that the trial court erred only in stating its conclusion of law respecting the validity of the declaration of the dividend; and in that respect the judgment is reversed with directions to the trial court to restate its conclusion of law in harmony with this opinion and for proper adjustment in the amount of recovery. In all other respects the judgment of the District Court is affirmed.

On Petition for Rehearing.

* * * Our conclusion is that the trial court erred only in stating as its conclusion of law that the dividend was ultra vires of the corporation and unlawfully charged to the surplus account of the corporation. To the extent that the decree rests upon that conclusion it is reversed and the cause remanded with directions to the trial court to modify conclusion of law No. 4 in its Findings of Fact and Conclusions of Law to conform to the holding of this Court respecting the validity of the declaration of the dividend of December 30, 1930; and the District Court is directed further to make such proper adjustments in the amounts of recovery against the defendants as are made necessary by our holding that the defendant Hogland was entitled to credit for the amount of the dividend as of the date it was credited to his account with plaintiff corporation. In all other respects the decree of the District Court is affirmed.

The language of the decree heretofore entered is modified accordingly.

Petition for rehearing is denied.

WITTENBERG v. FEDERAL MINING & SMELTING COMPANY.

Court of Chancery of Delaware, 1926. 15 Del.Ch. 147, 133 A. 48.

[Federal Mining & Smelting Co. was organized in Delaware in 1903, with an invested capital of $18,750,000. It had outstanding capital stock of 120,000 preferred and 50,400 common $100 par shares. The preferred stock was entitled to a 7% cumulative dividend before any dividends were paid on the common stock, and, upon dissolution, was entitled to payment of par and accrued dividends, before anything was paid to the common stock.

Defendant's business was the mining, smelting, etc. of mineral ores and marketing the finished product. Defendant acquired numerous mines, many of which have become exhausted. Its principal mine had a probable life of six years at the time of the present action; other mines had a life expectancy ranging from a few months to five years.

The corporate deficit as shown by the balance sheet in 1924 was $7,624,661.95. In 1924 it was more than $1,000,000 less than this sum. The balance sheet of December 31, 1924, showed that the capital assets were so depleted that they were then insufficient to pay the preferred stock, upon liquidation, the par value thereof.

Since 1906, the company had set up on its books amounts for depreciation of plants and equipment, but nothing for depletion of mines.

From 1904 to 1908, dividends were paid to the common stock aggregating 47½% of par; since then, the common stock had received no dividends. In 1926 there were unpaid back dividends accumulated on the preferred stock of $19.25 per share. At that time, the directors stated that the company's net profits for 1925 ($3,440,000 after all charges except depletion) were available for dividends to all stockholders, though the company's books showed a deficit; that, after preferred stock dividends were provided for, the company might distribute remaining net profits as dividends to the common stock without first deducting anything for depletion or establishing a sufficient reserve to pay off the preferred stock at par and unpaid dividends, in the event of the company's liquidation.

The directors then authorized the payment of accrued dividends ($19.25 per share) and the current quarterly dividend of 1¾% on the preferred stock and a special dividend of $10 per share on the common stock out of earnings prior to 1926. They announced a future policy of paying to the common stock half the current profits remaining after all charges except depletion, and after payment of all accrued and unpaid dividends to the preferred stock.

The present bill was brought by preferred stockholders for an injunction to restrain the payment of the declared dividend of $10 a share on the common stock; to enjoin payment of dividends to the common stock until a reserve fund be set up equal to the amount by which the invested capital had been impaired by depletion of the mines; and to restrain payment of any dividends on the common stock when such payment would impair the invested capital. In the alternative, an injunction restraining the payment of dividends on the common stock until a reserve fund be set up equal to the difference between the net value of the present assets and the par value of all outstanding preferred stock, was sought; thereafter, no dividends to be paid on the common stock if, as a result, net assets would be reduced below the par of all outstanding preferred stock. Defendant demurred.]

THE CHANCELLOR. * * * The general rule is that corporations cannot declare dividends except out of profits. This rule requires that the invested capital shall be kept intact. 1 Morawetz on Private Corporations, 2d Ed., § 435; 6 Fletcher's Cyclopedia of Corporations, §§ 3660, 3685; 5 Thompson on Corporations, 2d Ed., § 5305; 2 Machen on Modern Law of Corporations, § 1313; 2 Cook on Corporations, 8th Ed., § 546. As I read the briefs there is no dispute between the solicitors for the respective parties upon the proposition that this is the rule for corporations generally. But the defendant contends that if the corporation be a mining company, or an oil company, or a concern that is exploiting a patent or a leasehold, profits may exist notwithstanding there be a depletion of the corporate capital. Companies of this kind are said to be wasting asset corporations. It is understood by everybody that such concerns live on themselves; they thrive by consuming their capital. Every ton of ore taken from a mining company's mine and every barrel of oil taken from an oil company's wells depletes the capital pro tanto. So does the mere passage of time deplete the assets of a company organized to exploit a patent or a leasehold. In this re-

spect wasting asset corporations are distinguishable from the ordinary mercantile or manufacturing concern. Stockholders are entitled to expect the latter, unlike the former, to employ their capital in the acquisition of profits and not to dissipate it in driblets in the form of dividends. There being this difference in the nature of the two types of corporations, it is argued that while profits cannot be said to have been earned in the case of the ordinary industrial enterprise so long as an unrecouped portion of the capital has been lost, yet in the case of the wasting asset corporation profits as the term is understood may exist even though the capital has been and is being depleted. If capital assets consisting of ore are taken out of the ground, their transmutation into the form of a pure metal does not destroy their character as capital. If it be conceded that the proceeds from their sale, less only the cost of mining, milling, marketing and overhead, may be regarded as available for dividends, the result nevertheless remains, that dividends are being paid in part at least from capital, there being no charge-off for the value of the removed ore. To describe earnings so derived as profits is totally unjustified in reason, so far I mean as the same are contributed to by the value of the ore taken out. If, therefore, the defendant can be permitted to regard the value of its ore taken out as available for dividends, it must be on the theory, not that its value has ceased to represent a capital asset and may properly be regarded as contributing to "profits," but on the theory that with mining companies the general rule which forbids the making of dividends out of capital is not applicable. The use of the word "profits" in connection with this aspect of the subject is a misnomer. A dividend, when made from proceeds constituted as were those in this case, is made in part at least from capital invested and not from profits.

Now, aside from all statutory provisions, Is there any authority to the effect that proceeds derived in reality from capital assets, in the form of ore, may be regarded as available for dividends? If so, it is apparent that in the case of a mine the day is sure to arrive when the continued operation of the mine will have exhausted it, and the stockholders will find that all their capital has been paid out to them in installments in the form of dividends. If there is only one class of stock, so far as stockholders are concerned no harm can be done by such a course of conduct, beyond the possibility that some of them may perhaps have not appreciated the fact that dividends so received really constitute a partial distribution of capital and so may have been deluded into losing their investment by spending all the dividends upon the theory that they represented earnings or profits as generally understood. Certain it is, however, that where this is done, each stockholder (there being but one class) will have ultimately received his pro rata share of the capital assets. Instead of receiving such share in a lump sum as upon liquidation, he will have received it by bits in the course of what might be called a liquidation of capital by installments.

If, therefore, there is no statute to interfere, and creditors are not involved, it may with some reason be argued that a so-called wasting asset corporation ought to be permitted to write off nothing for its depleted capital assets when there are no preferences among stockhold-

ers, because unless this be so the only alternative would be for it to accumulate great cash reserves simply to abide the approach of a distant day for final distribution. Why not, reason suggests, permit the cash equivalent of consumed capital to be distributed to its ultimate owners pari passu with its accumulation, instead of compelling the mining or oil producing corporation to turn itself into what the solicitors for the defendant describe as a huge investment trust for the investment of accumulated cash reserves—an activity entirely unrelated to the sort of enterprise which the corporation and its officers are supposed to be especially equipped for?

In line with this reasoning the defendant cites the English case of Lee v. Neuchatel Asphalt Co., 1889, 41 Ch.Div. 1, 58 L.J.Chan.Div. 408, 1889, as authority for the proposition that value of the ore in place and removed need not be charged off against receipts from which dividends may be declared. That case does so hold. It appears to be the leading authority on the subject. As I read that case, however, it has no persuasiveness as an authority in the instant one. This is for two principal reasons. First, the facts of that case show that the capital was not only not depleted, but on the contrary had increased. Here there is a large depletion. And second, though there were two classes of shares, viz., preference and ordinary, yet with respect to capital all the shares were on the same footing. The preference shares were entitled to be preferred only in the matter of dividends, the article as to dividends being that the preference shares should first receive seven pounds per annum, then the ordinary shares should receive a like sum, and thereafter both classes should receive dividends without preference or distinction. In the instant case, however, a highly important distinction exists in the fact that the preferred shares are upon liquidation preferred over the common in the distribution of the capital. In the English case, if dividends had been made out of capital, the result would have been simply that each shareholder would have received, in bits to be sure, but nevertheless in its entirety, all that portion of the capital which each under the articles was entitled to. Now that is a very different case from this one. Here the preferred stockholders have a first claim not only on profits, but as well on the capital. The result will be that if the policy disclosed by the resolution which has already been acted upon and is proposed to be continued, is allowed to go on, the inevitable end will be that the mines will eventually become exhausted, the capital value represented by them will have become lost to the preferred stockholders who have a first claim thereon, and appropriated to the junior common stockholders in the shape of dividends. This thought is especially emphasized in the instant case because, unless new mines are found (a thing becoming increasingly difficult of realization), the present mines will, according to the facts before me, probably be exhausted within only six years from this date, and in the interval most of the remaining capital assets may be paid out in dividends to the common stockholders. The injustice of this result is the more glaring when it is remembered that the preferred stockholders have invested about twice as much money in the corporation's assets as have the common stockholders. The defendant frankly concedes that if its con-

tention is sustained, all that a preferred stockholder, who has a senior charge on capital as well as dividends, is assured of from the corporation is a right to a series of dividends while the assets last and that the common stockholders may be paid all proceeds from the sale of the transformed capital without any deduction for its value in the raw state. If this be true, such preferred stock of a wasting asset corporation as we are concerned with in the instant case is grossly misnamed. The common stock is the real preferred, for in the end it may receive not only so much of the capital as equals its par, but all that there is in excess of its par, leaving possibly not so much as a crumb for its supposedly more favored companion. And this situation is aggravated in the case of a corporation where as in this one the preferred stockholders are denied either the right to vote at stockholders' meetings or to have notice of the same. * * * It seems clear to me that on fundamental principles of right and justice, the complainants as preferred stockholders possessing a prior claim on capital assets have an equity which entitles them to protection against the proposed whittling away of those assets for the benefit of the less favored common stockholders.

To the suggestion that the contentions of the complainants, if sustained, might result in the creation of what the defendant, as before stated, describes as an investment trust for the investment of large reserves, two things are to be said. They are, first, that cash or securities need not be hoarded if other mines are desired to be purchased, or if not and it is undesirable for any reason that the directors should invest the cash, preferred stock may be purchased on the open market or the capital stock may from time to time be reduced in accordance with the provisions of the act in that behalf.

There being no right under general principles for the corporation to pay out dividends to the common stockholders under the present financial condition of the company, is there anything in our statute authorizing the proposed dividends? This is the next question to be answered.

Our pertinent statutory provisions are found in the General Corporation Law. They are as follows:

"Sec. 13. [After authorizing the issuance of preferred stock and the payment of preferred dividends thereon, the section proceeds in this language:] And when any such quarterly, half yearly or yearly preferred dividend shall have been paid or set aside as herein provided, a dividend upon the common stock may then be paid out of the remaining surplus or net profits of the company." 29 Del.Laws, c. 113, § 7.

"Sec. 34. *Dividends; Reserves:*—The directors of every corporation created under this chapter shall have power, after reserving over and above its capital stock paid in, such sum, if any, as shall have been fixed by the stockholders, to declare a dividend among its stockholders of the whole of its accumulated profits, in excess of the amount so reserved, and pay the same to such stockholders on demand; provided, that the corporation may, in its certificate of incorporation, [or] in its by-laws, give the Directors power to fix the amount to be reserved." Rev. Code 1915, § 1948.

"Sec. 35. * * * No corporation created under the provisions of this chapter, nor the directors thereof, shall make dividends except from the surplus or net profits. * * *" Rev.Code 1915, § 1949. * * *

Now, what do our statutory provisions touching dividends mean? Sections 34 and 35 are the most important sections bearing on this question. Whatever meaning is given to the words "accumulated profits" in section 34 and "surplus or net profits" in section 35, will give color and complexion to the phrase "remaining surplus or net profits" as it appears in section 13. I, therefore, address my attention to sections 34 and 35 as controlling. In examining these sections their meaning with respect to corporations generally will be sought to be extracted without regard to whether the corporation is an ordinary industrial one or one known as a wasting asset corporation.

If section 34 stood alone, I suppose there could be no doubt that if a corporation found its capital assets reduced below their paid in value, no matter what may have been the profits in the last current year out of which dividends could be made, no dividend could be declared without first bringing the capital up to its paid in value. But the defendant argues that section 34 is simply a permissive section, it does not assume to lay down a rule of prohibition, and it is not permissible in view of section 35 which follows with its inhibition, to infer that section 34 on the principle of expressio unius est exclusio alterius is designed to say when dividends may not be declared. Therefore, says the defendant, we are to look to section 35 to see if a proposed dividend falls under the ban of any of its prohibitions. If it does not, then that section being the only one of inhibition, there is no statutory rule anywhere forbidding the dividend. Furthermore, it is contended that though section 35 is negative in its provision, yet it is also positive and affirmative by reason of the exception contained in it. In other words, it is as though it should read "corporations may make dividends out of surplus or net profits."

Now the word "or" being in the disjunctive, it is contended that the section points out two sources from which dividends may be declared, viz., surplus if any, or even though there is no surplus, yet from net profits in any current year in case such are earned. The force of this argument is particularly pointed out in this case, for it is contended that though the company's balance sheet shows a capital deficit, its profit and loss account for 1925 shows net profits in the sum of $3,440,000. To what extent the value of extracted ore which is not charged off against earnings contributes to this sum does not appear. But even if none were attributable to extracted ore, still a deficit exists.

Section 35 was taken from the New Jersey act (P.L.1896, p. 277). Its counterpart in that act is section 30, N.J.S.A. 14:8–19. It is interesting to note that the New Jersey act has been amended since our act was adopted by making the language read "except from its surplus, or from its net profits." The introduction of that word "from" after the disjunctive conjunction has the evident effect of pointing out two funds from which dividends may be made. Goodnow v. American Writing Paper Co., 69 A. 1014, 73 N.J.Eq. 692. Our section, however, remains as originally drawn. Evidently the New Jersey amendatory

legislation was regarded as necessary to make it clear that two such funds were created. The Court of Errors and Appeals of New Jersey in the Goodnow Case took occasion to say that when this section 30 was in the same condition as our section 35 is in, there was room to contend that the words "net profits" were intended to be synonymous with the word "surplus." And even after the amendment was adopted, which clearly indicated two funds from which dividends might be made, the court refused to define "net profits" as profits made in any one year. Its language on this point was as follows:

"Although the change in language indicates that the Legislature made a distinction between surplus and net profits, it does not necessarily follow that net profits mean the difference between gross earnings and what may be called operating expenses. Such profits may be called annual profits, and it may be that by net profits the Legislature meant the net profits upon the whole of the company's business from its organization. If either of these meanings is adopted, the declaration of the present dividend is justified."

And so here, when the advantage to the dividend lacks the aid of those words "or from," it may with more reason be said that by net profits is meant the net profits upon the business from its organization. Taking section 35 in connection with section 34 with which it of course must be construed, my conclusion is that the net profits are such as appear from the entire business of the company from its inception, and are not to be confined to one period and made synonymous with annual profits. This being the construction adopted, there are no net profits because the capital is heavily depleted.

Whether "net profits" is synonymous with surplus I shall not pause to discuss. It may be argued that it is not, and if not, then two funds exist from either of which dividends could be made and the paid in capital left undisturbed. In other words it may be argued that surplus can be created from a source other than profits, as for instance from sale of stock at a premium. In that event, though there are no net profits or accumulated profits from which to make a dividend, yet another fund, viz., the surplus, might be argued to exist to which resort may be had for a dividend. And so on this argument, the statute may be construed as referring to two distinct dividend funds the existence of both of which is not inconsistent with the statutory conception that the paid in capital must always be maintained.

But whatever might be the correct view upon the question of whether "surplus" and "net profits" are synonymous, I am of the opinion that in this case there are no "net profits" within the meaning of the statute and certainly there is no "surplus."

In this view of our statute there is thus nothing therein which against the preferred stockholders authorizes the dividend already declared or permits similar common stock dividends in the future so long as the capital is impaired. * * *

All that has hereinbefore been said should of course be understood as being confined solely to controversies intra the corporation. If cred-

itors' rights are involved, an entirely different situation would be presented for consideration.

The demurrer will be overruled.[11]

(b) *Dividends Other Than Cash*

(1) STOCK DIVIDENDS

Stockholders not infrequently receive as a distribution, additional shares of stock in the corporation. Such distribution may be

(a) A true "stock dividend." Here, the directors have by resolution transferred a portion of surplus to capital; and such transfer is treated as consideration for the issue of new shares, which are then directed to be distributed, *pro rata,* as a dividend to shareholders.

(b) A "split-up". Here the directors, without adding to capital amend the certificate by dividing the existing outstanding shares into a greater number; and issuing by exchange or otherwise, a suitable number of additional shares.

It will be noted that under (a) surplus equal to the par values of the added shares must be transferred to capital. Quære: how much surplus must be transferred in respect of stock dividends of non-par stock? Must the same amount of surplus per share, be transferred to capital as was paid in when the original shares on which the dividend is to be paid were issued? If not, may not the old shares be diluted by the so-called "dividend" ?

WILLIAMS v. WESTERN UNION TELEGRAPH CO.

Court of Appeals of New York, 1883. 93 N.Y. 162.

EARL, J. * * * The main contention[12] was, that the stock dividend distributing upwards of $15,000,000 of stock among the stockholders of the Western Union Telegraph Company, was unauthorized and in violation of law, and whether it was or not is the principal matter for our determination upon this appeal.

The stock dividend was claimed to be in violation of chapter 18, part 1, title 4, section 2 of the Revised Statutes [1829, Vol. 2][13] * * *

This dividend was condemned by the General Term of the Superior Court as a violation of that section. Our attention has been called to

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[11] Aff'd, 15 Del.Ch. 409, 138 A. 347, 55 A.L.R. 1, 1927; after trial, bill dismissed, 15 Del.Ch. 351, 138 A. 352, 1927. Compare Delaware General Corporation Law, § 34, supra p. 385.

Weiner, Theory of Anglo American Dividend Law: American Statutes and Cases, 1929, 29 Col.L.Rev. 461, 479; Notes, 1926, 12 Corn.L.Q. 79; 1927, 5 N.Y.U.L.Q.Rev. 40; 1927, 75 U. of Pa.L.Rev. 350; 1926, 40 Harv.L.Rev. 318; 1928, 26 Mich.L.Rev. 448; 1928, 12 Minn.L.Rev. 178; 1926, 75 U. of Pa.L.Rev. 89.

The problems created by the "wasting asset" doctrine are discussed: Ballantine and Hills, Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws, 1935, 23 Calif.L.Rev. 229, 248–252; Frey, The Distribution of Corporate Dividends 1941, 89 U. of Pa.L.Rev. 735, 749; Weiner, Theory of Anglo American Dividend Law: American Statutes and Cases, 1929, 29 Col.L.Rev. 461, 477; Williams, Dividends from Wasting Asset Corporations, 1936, 43 W.Va. L.Q. 53.

[12] Statement of facts appears *supra*, p. 212.

[13] See f. n. 1, *supra*, p. 212.

Cf. N.Y.Stock Corporation Law, § 58, *supra*, p. 384.

no other law forbidding or condemning a stock dividend, and in their allegations against it the counsel for the plaintiff rely mainly upon that section. After reading the numerous opinions that have been submitted to us and giving careful attention to all that has been said upon the subject, we are unable to perceive that that section has any bearing whatever upon the question we are to determine. The section was taken from the act chapter 325 of the Laws of 1825, which was entitled, "An act to prevent fraudulent bankruptcies of incorporated companies, to facilitate proceedings against them, and for other purposes." It was not part of the original revision, but was incorporated into the Revised Statutes by Chapter 20 of the Laws of 1828. A careful reading of the section shows that it has reference only to the property capital of a corporation, and not to its share capital. The first clause prohibits dividends of property except from surplus profits. It is further provided that the directors of any corporation shall not divide, withdraw or in any way pay to the stockholders, or any of them, any part of the capital stock of such company, or to reduce the capital stock without the consent of the legislature. These provisions were intended to prevent the division, distribution, withdrawal and reduction of the property of a corporation below the sum limited in its charter or articles of association for its capital, but not to prevent its increase above that sum. The purpose was to prevent the depletion of the property of the corporation thereby endangering its solvency. * * * By loss or misfortune, or misconduct of the managing officers of a corporation, its capital stock may be reduced below the amount limited by its charter; but whatever property it has up to that limit must be regarded as its capital stock. When its property exceeds that limit, then the excess is surplus. Such surplus belongs to the corporation and is a portion of its property, and, in a general sense, may be regarded as a portion of its capital, but in a strictly legal sense it is not a portion of its capital, and is always regarded as surplus profits. The very section we are considering contemplates that there may be a surplus, and that such surplus may be divided. The surplus may be in cash, and then it may be divided in cash; it may be in property, and if the property is so situated that a division thereof among the stockholders is practicable, a dividend in property may be declared, and that may be distributed among stockholders. All such dividends diminish and deplete the property of the corporation, and that section was designed to prevent dividends of property which tended to deplete the assets of the company below the sum limited in its charter as the amount of its capital stock. But stock dividends never diminish or interfere with the property of a corporation, and hence are not within the purview of that section. After a stock dividend a corporation has just as much property as it had before. It is just as solvent and just as capable of meeting all demands upon it. After such a dividend the aggregate of the stockholders own no more interest in the corporation than before. The whole number of shares before the stock dividend represented the whole property of the corporation, and after the dividend they represent that and no more. A stock dividend does not distribute property, but simply dilutes the

shares as they existed before; and hence that section in no way prevented or related to a stock dividend. Such a dividend could be declared by a corporation without violating its letter, its spirit or its purpose. It is, therefore, clear that the directors of the Western Union Telegraph Company did not violate that section by the stock dividend which they declared; and if that dividend was illegal it must be because it was condemned by some other statute, or by some general principle of law or by public policy.

Our attention has been called to no statute, and we know of none in this State which prohibits a corporation from making a stock dividend. The legislatures in some of the States have, we believe, passed laws prohibiting such dividends; but in this State no such law has been enacted.

There is no public policy which in all cases, condemns such dividends. Shares having been legally brought into existence may be distributed among the stockholders of a company. By such distribution no harm is done to any person, provided the dividend is not a mere inflation of the stock of the company, with no corresponding values to answer to the stock distributed. It may be that a distribution of stock gratuitously to the stockholders of a company based upon no values, a mere inflation, or, to use a phrase much in vogue, a watering of stock, would be condemned by the law. But when stock has been lawfully created and is held by a corporation, which it has a right to issue for value, then a stock dividend may be made, provided that the stock always represents property. It is conceded that the directors of the Western Union Telegraph Company could have issued this stock for money to be paid into its treasury. It could have issued it for property to be received by it for the purposes of its legitimate business. But here it is found that over and above its capital it possessed property actually worth upwards of $15,000,000, and we know of no law that is violated, and no public policy that is invaded by issuing to the stockholders stock to represent that amount of property rather than in any mode to divide it up and distribute it among them. If it can issue stock in payment of property to be obtained by it as part of its capital for its legitimate uses, why may it not issue stock to its stockholders in payment for property in effect purchased of them and added to its permanent capital, and which they relinquish the right to have divided? So long as every dollar of stock issued by a corporation is represented by a dollar of property, no harm can result to individuals or the public from distributing the stock to the stockholders. Here there was no fraud, no conspiracy, no unlawful combination, and we are bound, under the findings of the court at Special Term, to assume that all this was done in good faith; and we know of no principle of law, no public policy, and no statute that condemns a stock dividend under such circumstances. * * * [Citations omitted.]

It is true that this dividend largely increases the capital stock of the company, but that is not against the policy of our laws. That cannot be against the policy of the law which the law expressly permits. There is no limit to the capital which business corporations in this State may have, and there is no limit in the law beyond which they may not in-

crease their capital. All that can be required in any case is that there shall be an actual capital in property representing the amount of share capital issued. Indeed, so far as the solvency and responsibility of a corporation is concerned, they are increased by a stock dividend where it has a surplus of property to correspond to the amount of shares issued. In such case the surplus property is secured and impounded for the benefit of the creditors of the corporation and for the public, so that thereafter it can never be legally divided, withdrawn or dissipated in any way.

But if it can be conceived that this was a dividend of property within the meaning of the section of the Revised Statutes above set out, then what property did it divide? Not any portion of the capital of the company; that remained intact. After subtracting the dividend there remained to the company the full amount of its prior stock, to-wit: Property to the value of $41,073,410. Such is the finding of the trial court, and that cannot here be disputed. The company had made surplus earnings which it could have divided, but instead of dividing them it had invested them in property to facilitate and enlarge its business; and such property was found to be worth $15,526,590. That sum constituted its surplus. It was commingled with the other property of the company and used for corporate purposes. But it was not beyond the reach of the dividend-making power of the directors. They could reclaim it for division among the stockholders, and, if practicable, convert it into cash for that purpose. They could borrow money on the faith of it and divide that. They could issue to the stockholders certificates of indebtedness, redeemable in the future, representing their respective interests in such surplus, thus, in effect, borrowing the same of the stockholders. Desiring to use the surplus and add it to the permanent capital of the company, and having lawfully created shares of stock, they could issue to the stockholders such shares to represent their respective interests in such surplus. In doing these things no law would be violated, the capital would be kept intact, and no stockholders or creditors would have any legal right to complain. All this, however, depends upon the findings of the trial court that the surplus is equal to the dividend. That finding is not open to criticism here. It was not disturbed at the General Term and therefore concludes us.

When a corporation has a surplus, whether a dividend shall be made, and if made, how much it shall be, and when and where it shall be payable, rest in the fair and honest discretion of the directors uncontrollable by the courts. Brown v. Monmouthshire R'y & C. Co., 4 Eng.L. & Eq. 118; Rex v. Bank of England, 2 Barn. & Ald. 620; Jackson's Adm'rs v. Newark Plank Road Co., 31 N.J.L. 277; Ely v. Sprague, Clark's Ch. 351. There is no statute which requires dividends in telegraph companies or in companies generally to be made in cash. Whether they shall be made in cash or property must also rest in the discretion of the directors. There is no rule or law or reason founded upon public policy which condemns a property dividend. The directors could convert the property into cash before a dividend and divide that. So the stockholders can take the property divided to them and

sell it and thus realize the cash. Within the domain of law, it can make no material difference which course is pursued. If, however, a dividend be made payable in cash or payable generally, the corporation becomes a debtor, and must discharge such debt, as it is bound to discharge all its other debts, in lawful currency. It is true that a stockholder cannot be compelled to receive property divided to him. So he cannot be compelled to take a cash dividend. In case of his refusal to take a cash dividend, the corporation may retain it for him until he shall demand it. In case he shall refuse to take a property dividend, the corporation may retain it and hold it in trust for him, or possibly sell it for his benefit. If such a case shall ever arise, the courts will find some way to dispose of it. So this plaintiff cannot be compelled to accept the stock divided to him, and thus incur the possible liability which it may impose upon him as a stockholder. In case of his refusal, the corporation will find some way to deal with the stock which the law will sanction, but which need not now be pointed out.

We have no occasion to scrutinize the motives of the defendants. The trial judge refused to find the alleged fraud and conspiracy, and his finding concludes us. In his opinion he said: "I have also found that the other allegations of fraud and conspiracy made in the complaint against the defendants and others were not proved on the trial. One of the very able counsel for the plaintiff, in his argument at the close of the trial in this case, said that he was not going to lament the fact that he had failed to show such combination, that he had not been able to prove certain things by the defendants;" and the opinion of the court at the General Term is to the same effect; "The complaint, among other things, charges that the corporate action complained of was the result of a fraudulent conspiracy on the part of the individual defendants, but the allegations in that respect were not sustained by the proof at the trial, nor has there been an argument made in their support upon the present appeal."

We are therefore, of opinion upon the facts, found at Special Term, that the stock dividend was authorized by law and, therefore, valid. * * *

Order of General Term reversed and judgment accordingly.[14]

NOTES

(A) "To maintain that a share dividend is merely a bookkeeping transaction is to ignore realities; it is demonstrable that, all other factors remaining the same, the declaration of a share dividend normally results in an appreciation of the shares outstanding; furthermore, the payment of a share dividend at once alters

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[14] On the nature of a stock dividend, see: Berle and Means, The Modern Corporation and Private Property, 1932, 197–199; Reiter, Profits, Dividends and the Law, 1926, 203–206; Seligman, Studies in Public Finance, 1925, c. 5, esp. 115 et seq.; Ballantine and Hills, Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws, 1935, 23 Calif.L.Rev. 229, 255; Hills, Model Corporation Act, 1935, 48 Harv.L.Rev. 1334, 1368–1370; Sparger, Profits, Surplus and the Payment of Dividends, 1929, 8 N.C.L.Rev. 14, 24–27.

See, Katz, Accounting Problems in Corporate Distributions, 1941, 89 U. of Pa.L. Rev. 764, 774–776.

the shareholder's position by reducing the corporate funds available for cash distribution, and in order to realize the cash which he might formerly have received by way of a cash dividend, the shareholder must sell some of his shares and thus decrease his proportionate interest in voting control and in assets and net earnings." Note, 1930, 39 Yale L.J. 1163, 1169–1170.

(B) If a stockholder is entitled only to a fractional part of a share of dividend stock, he may be given, (1) a cash payment representing the fractional share; (2) scrip exchangeable for shares; [15] or (3) a credit toward a full share. See, Waring, Fractional Shares under Stock Dividend Declarations, 1931, 44 Harv.L.Rev. 404.

POWELL et al. v. MARYLAND TRUST COMPANY.

Circuit Court of Appeals of the United States, Fourth Circuit, 1942.[16] 125 F.2d 260.

Action between Legh R. Powell, Jr., and another, as receivers of the properties of Seaboard Air Line Railway Company, the New York Trust Company, and another as trustees of the Seaboard Air Line Railway refunding mortgage and the Maryland Trust Company, as successor trustee under the first mortgage of Seaboard Air Line Railway dated April 14, 1900. From the decree, Legh R. Powell, Jr., and another, as receivers of the properties of the Seaboard Air Line Railway Company and the New York Trust Company and another, as trustees of Seaboard Air Line Railway refunding mortgage, appeal, and Maryland Trust Company, as successor trustee, cross-appeals.

Decree modified, and, as modified, affirmed.

PARKER, CIRCUIT JUDGE. These are appeals in a three-sided controversy which has arisen in the receivership of the Seaboard Air Line Railway Company, with relation to a stock dividend and certain cash dividends on stock owned by the Seaboard in the Richmond-Washington company and pledged with the predecessor of the Maryland Trust Company, as trustee. This stock, 4,450 shares in amount, was pledged in 1901 by the corporation to whose rights the Seaboard succeeded with the Continental Trust Company, predecessor of the Maryland Trust Company, as trustee under a first mortgage executed to secure a bond issue. On October 18, 1930 a 50% stock dividend was declared on this stock; and on October 31, 1930, certificates for 2,225 shares were delivered to the Seaboard as the stock dividend on its shares. On December 23, 1930, receivers were appointed for the Seaboard, and the certificates representing the stock dividend passed into their possession. The receivers collected cash dividends on the original shares of stock up to January 4, 1932, and on the stock dividend shares up to the time of the decree of the court below.

The Maryland Trust Company, the trustee under the first mortgage, claims both the stock dividend and the total of the cash dividends by

[15] Some states make express statutory provision for the issuance of scrip to represent ownership of a fractional share of stock. E. g., Ill.Business Corporation Act, § 22, Smith-Hurd Stats. c. 32, § 157.22; Ohio Gen.Code, § 8623–30. Conn.Gen. Stat. 1930, § 3417, expressly prohibits the issue of any certificates representing fractional shares. Whenever fractional rights result from an increase or reduction of capital stock, and these rights are not bought or sold by the stockholders, the directors must sell such rights to the highest bidder and issue proper certificates therefor.

[16] Cert. denied 316 U.S. 671, 62 S.Ct. 1041 (1942).

virtue of the rights vested in it by the pledge of the original shares of stock under the first mortgage. The receivers deny the right of the first mortgage trustee to either the stock dividend or the cash dividends, claim a lien on both under the order appointing receivers and also under the orders authorizing issuance of receivers' certificates and assert that any rights of the first mortgage trustee have been lost by waiver and estoppel. The New York Trust Company joins the receivers in denying the right of the first mortgage trustee to the shares of stock represented by the stock dividend and also to the cash dividends paid thereon, but claims for itself these shares of stock and cash dividends under the terms of a refunding mortgage executed by the Seaboard.

The controversy was referred by the court below to the late J. E. Heath, as special master, who in an able and comprehensive report found for the first mortgage trustee both as to the stock dividend and the total of the cash dividends claimed. This report was affirmed by the judge in all respects, except as to a cash dividend of $20,025 paid December 31, 1930, which he held to belong to the receivers. From this decree all parties have appealed; and in the view which we take of the case four questions are presented for our determination, viz: (1) Did the stock dividend on the Richmond-Washington stock belong to the first mortgage trustee? (2) Was the first mortgage trustee entitled to the cash dividends mentioned, including the $20,025 paid December 31, 1930? (3) Were the receivers vested with a lien upon either the stock dividend or the cash dividends by the order appointing receivers or the orders authorizing issuance of receivers' certificates? (4) Have the rights of the first mortgage trustee with respect either to the stock or the cash dividends been lost by waiver or estoppel? We think that the first two of these questions should be answered in the affirmative and the last two in the negative. We shall consider them separately and in the order named. The answers to the first two questions render it unnecessary to consider a number of subsidiary questions arising in connection with the contentions of the New York Trust Company.

1. The Stock Dividend.

The Seaboard Air Line was one of six railroads which owned in equal shares the stock of the Richmond-Washington Company, a holding company which owned the Richmond Fredericksburg & Potomac Railroad, over which the trains of the Seaboard are operated between Richmond and Washington. It originally held 4,450 shares of this Richmond-Washington stock, which in the year 1901 it pledged with the Continental Trust Company, predecessor of the Maryland Trust Company, as trustee under a first mortgage to secure a bond issue. The stock is not expressly mentioned in the mortgage, which provides, however, for the pledging of stocks, bonds and other property to the trustee to be held subject to the terms of the mortgage. Section 1 of article III of the mortgage contains the following provision: "Unless (a) the 'Railroad Company' shall be in default in the payment of

some interest upon any of the bonds secured by this indenture, or on any of said outstanding divisional bonds (other than bonds held by the 'Trustee' hereunder), and such default shall have continued for a period of six months; or unless (b) the 'Railroad Company' shall be in default in the due and punctual payment of the principal of any bond secured hereby, or of any of said outstanding divisional bonds hereinbefore mentioned; or unless (c) the 'Railroad Company' shall be in default in the payment of any tax, assessment or other governmental charge lawfully imposed or levied upon any part of the property and premises hereby mortgaged, or the income and profits thereof, and such default shall have continued for a period of six months, after written notice thereof from the 'Trustee,' or from the holders of five per cent in amount of the bonds secured hereby; or unless (d) the 'Railroad Company' shall be in default in the due performance and observance of any covenant or condition of this indenture, and such default shall have continued beyond the period of grace, if any, herein provided for, in respect of such default, and the 'Trustee' shall have entered, or shall have elected to enter, into possession under the power of entry hereinafter conferred; or unless (e) the 'Railroad Company' voluntarily shall have surrendered to the 'Trustee' possession of the mortgaged premises as hereinafter authorized—the 'Trustee' (except with the assent of the 'Railroad Company') shall not collect or be entitled to collect the interest of any of the bonds or claims or indebtedness now or hereafter pledged with or assigned to the 'Trustee' under this indenture, and the 'Railroad Company' shall be entitled to receive all interest paid or dividends declared in respect of any bonds or stocks transferred to or pledged with the 'Trustee' pursuant to any of the provisions of this indenture, * * *."

On September 18, 1930 the Board of Directors of the Richmond-Washington Company voted a stock dividend of 50%, payable in stock October 31, 1930; and on the last named date certificates evidencing 2,225 shares of the capital stock of the company were delivered to the Seaboard as stock dividend on the 4,450 shares which it held and which it had pledged with the first mortgage trustee. Receivers were appointed for the Seaboard on December 23, 1930, and these certificates, of which the first mortgage trustee had no notice or knowledge until some time later, passed into their possession. The evidence shows that the earnings of the Richmond-Washington Company which justified the declaration of the stock dividend accrued subsequent to the pledge of the stock with the first mortgage trustee. It shows, also, what is to be expected in such cases, that immediately following the stock dividend the total book value of the original shares plus the shares issued as stock dividend was precisely the same as the book value of the original shares immediately prior to the dividend. The book value of each of the shares of stock immediately prior to the stock dividend was $263.75, immediately after the dividend, $175.83.

The mortgage was delivered to the first mortgage trustee and accepted by it in Baltimore, Md., and the shares of stock which were pledged were delivered to it there; and there is no serious question but that the law of Maryland is the law properly applicable in de-

termining the rights of the parties with respect to the stock dividend.

In the absence of the provision of the mortgage quoted above, there could be no question but that the shares of stock issued as stock dividend would go to the first mortgage trustee, as pledgee of the original shares of stock, to be held by it under the terms of the pledge. Gemmell v. Davis, 75 Md. 543, 23 A. 1032, 32 Am.St.Rep. 412; Railroad Credit Corp. v. Hawkins, 4 Cir., 80 F.2d 818; Jones on Collateral Securities, 3d Ed., sec. 298. The question involved, therefore, is the interpretation of the word "dividends" as contained in the provision under which "dividends" were reserved to the Seaboard, i.e. was the reservation to the Seaboard of the right to "dividends" until default under the mortgage intended to reserve to it the right to stock dividends? We think the answer to this must be in the negative, both because a contrary interpretation would be unreasonable in the light of surrounding circumstances, and because, even in the absence of such circumstances, a stock dividend is not ordinarily included in the term "dividends" as contained in a contract relating to dividends, in the absence of a clear indication that it was intended that they should be so included.

It must be remembered that the Richmond-Washington stock pledged by the Seaboard with the first mortgage trustee represented a one-sixth interest in the railroad over which the trains of the Seaboard between Richmond and Washington were operated; and the fair inference is that it was intended that this interest in the road was to remain pledged with the trustee as security for the bonds. Cash dividends on the stock i. e. amounts paid in cash to stockholders from the earnings of the corporation, were to be enjoyed by the Seaboard so long as it was not in default; but it is hardly to be supposed that the parties could have intended that the Seaboard should have free of the pledge a stock dividend representing a mere capital readjustment, and that the proportionate interest of the first mortgage trustee in the property represented by the stock which had been pledged with it should be thus reduced. The fact that the mortgage contained specific provision that "consolidation, merger, sale or lease" of any company whose stock was pledged with the first mortgage trustee might be made only "upon such terms as shall not in any manner impair the value of the security hereunder" (art. III sec. 6) shows a clear intention that the value of the security pledged should not be impaired by corporate manipulation. And nothing to the contrary is to be inferred from the anti-dilution clause of article II section 8 of the mortgage. Provision was made therein for the preservation of rights in the properties of constituent companies, the majority of whose stock had been assigned to the trustee; but this does not in any way indicate an intention that the rights of the trustee in properties represented by other stocks pledged might be decreased by allowing the Seaboard to have free of pledge stock dividends which might be declared with respect thereto. If any inference is to be drawn from this anti-dilution clause, it is favorable to the position of the first mortgage trustee rather than otherwise.

And quite apart from the peculiar circumstances of the case, which show very clearly, we think, that stock dividends were not intended to be included among the "dividends" reserved to the Seaboard by the terms of the mortgage, the rule is well settled that the word "dividends" in contracts relating to the sale or transfer of stocks is not ordinarily to be construed as embracing stock dividends, which are not true dividends at all but a mere certified expression of an undivided surplus and its capitalization. Eisner v. Macomber, 252 U.S. 189, 210, 211, 40 S.Ct. 189, 64 L.Ed. 521, 9 A.L.R. 1570. The precise question is not covered by any Maryland decision; but it is worthy of note that in the case of Smith v. Hooper, 95 Md. 16, 51 A. 844, 846, 54 A. 95, Chief Judge McSherry quotes with approval from Spooner v. Phillips, 62 Conn. 62, 24 A. 524, 16 L.R.A. 461, that "the word 'dividend,' if unqualified * * * signifies dividends payable in money." Mr. Justice Gray, speaking for the Supreme Court in Gibbons v. Mahon, 136 U.S. 549, 10 S.Ct. 1057, 1059, 34 L.Ed. 525, thus states the essential nature of a stock dividend: "A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of new ones."

And the distinction between the essential character of an ordinary dividend and a stock dividend is thus drawn in the opinion of the lower court in Gibbons v. Mahon, 4 Mackey 130, 136, 54 Am.Rep. 262, quoted with approval by Mr. Justice Gray in the Supreme Court: "Certificates of stock are simply the representative of the interest which the stockholder has in the capital of the corporation. Before the issue of these two hundred and eighty new shares, this trustee held precisely the same interest in this increased plant in the capital of the corporation, that she held afterwards. She merely had a new representative of an interest that she already owned, and which was not increased by the issue of the new shares. *A dividend is something with which the corporation parts, but it parted with nothing in issuing this new stock.* It simply gave a new evidence of ownership which already existed. They were not in any sense, therefore, dividends for which this trustee had to account to the cestui que trust. She stood, after the issue of the new shares, just as she had stood before; and the trustee was obliged to treat them just as she did, namely, as a part of the original, and to pay the dividends to the cestui que trust." (Italics supplied).

A stock dividend is not a true dividend because not involving a severance of corporate assets for distribution to stockholders, but is in its last analysis a mere incident or process of corporate bookkeeping. 18 C.J.S., Corporations, § 466, p. 1110. The word "dividend,"

when used without qualification or explanation, ordinarily signifies dividends paid in money. 13 A.J. p. 640. It involves a severance from corporate assets of an amount distributed to stockholders, but the stock dividend involves no such severance or distribution of assets. As said by the Supreme Court in Eisner v. Macomber,[17] supra, 252 U.S. 189, 211, 40 S.Ct. 189, 194, 64 L.Ed. 521, 9 A.L.R. 1570: "A 'stock dividend' shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution."

In McDonald v. Maxwell, 274 U.S. 91, 47 S.Ct. 497, 499, 71 L.Ed. 942, the Supreme Court refused to allow executors in the District of Columbia commissions on stock dividends, on the ground that such dividends represented no increase in the principal of the estate in their hands, saying: "It is apparent, in the light of these decisions, that the stock dividends received by the executors represented no real increase in the principal of the estate during the accounting period. They merely changed the form of the estate's investment in the corporate stocks by increasing the number of its shares, but left the aggregate value of all its shares the same as that before the dividend shares were issued. After their issuance, which necessarily 'diluted' the value of the original shares, the dividend shares and the original shares together represented the same proportional interest in the corporate properties that had previously been represented by the original shares alone; no more and no less."

In a controversy arising between a life tenant and remainderman as to the right to a stock dividend, the Supreme Court of Missouri, in Hayes v. St. Louis Union Trust Co., 317 Mo. 1028, 298 S.W. 91, 98, 56 A.L.R. 1276, 1285, a well considered decision, puts the matter thus: "A stock dividend is not in any true sense a dividend at all. The latter implies a division, a severance from the corporate assets of the subject of the dividend, and a distribution thereof among the stockholders. McLaran v. Crescent Planing Mill Co., 117 Mo.App. 40, 93 S.W. 819; 14 C.J. p. 798; 5 Thompson on Corporations 2d Ed. p. 84, § 5270. The issuance of a stock dividend is, in its last analysis, nothing more than an incident or process in corporation bookkeeping. The important step is the increasing of the fixed capital of the corporation. The outstanding shares of stock are increased to balance, either by adding to their number or raising their par value. When the stock

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17 There is nothing to the contrary in such cases as Koshland v. Helvering, 298 U.S. 441, 56 S.Ct. 767, 80 L.Ed. 1268, 105 A.L.R. 756, and United States v. Phellis, 257 U.S. 156, 42 S.Ct. 63, 66 L.Ed. 180, which hold that, for purposes of taxation, distinction must be drawn between a stock dividend which, like the one here involved, works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend which involves changes of corporate identity or a change in the nature of shares issued, whereby the proportional interest of the stockholder after distribution is essentially different from his former interest.

has no par value, it seems even this is unnecessary. Nothing is taken from the corporation. Nothing is given to the stockholders, rather the contrary, for corporate profits theretofore available for distribution in dividends are permanently appropriated to its fixed capital. The title to all corporate property remains in the corporation as before. The proportional interest of each stockholder continues the same; the only change is in the evidence of his interest in the corporation—that is, the number of his shares of stock is increased and the book value of each share correspondingly decreased, or the face value of his shares of stock is raised to or toward what their intrinsic value was before."

A case directly in point here, because dealing with a reservation of dividends, is Lancaster Trust Co. v. Mason, 152 N.C. 660, 68 S.E. 235, 236, 136 Am.St.Rep. 851. In that case an offer to sell corporate stock, which was accepted, contained the following expression, "allowing the January dividend to us". A stock dividend of 50% and a regular cash dividend of 4% and an extra cash dividend of 6% were declared in January. The Supreme Court of North Carolina held that both cash dividends were retained by the seller under this provision of the contract, but that the stock dividend went to the purchaser with the stock purchased. The court, citing the Maryland case of Smith v. Hooper, supra, said: "Upon a careful review of the correspondence between the parties and a further consideration of the case we are led to the conclusion that the words 'allowing the January dividend to us,' used in plaintiff's letter of December 23, 1907, were intended to refer to dividends payable in cash only, and do not embrace the so-called 'stock dividend' of 50 per cent. That was not strictly or in the usual sense of the word a dividend. It was simply an increase in the capital stock by dividing the capital of the corporation into a larger number of shares and allotting them to each stockholder in proportion to the number of shares he owned before the increase. This is not infrequent in these days when 'watering stock' is no uncommon occurrence; not that we mean to intimate that such has been the case here. *Therefore it has been held that where the word 'dividend' is used without qualification or explanation, it signifies dividends payable in money:* 14 Cyc. 554, and cases cited; Black, Law Dict.; 3 Words & Phrases [First Series] pp. 2143, 2144; Smith v. Hooper, 95 Md. 16, 51 A. 844, 54 A. 95." (Italics supplied.)

Kaufman v. Charlottesville Woolen Mills Co., 93 Va. 673, 25 S.E. 1003, 1004, was another case in which dividends on stock sold were retained by the seller. In holding that the word dividends did not include a stock dividend, the court said: "In the case at bar it is clear, on reason and authority, that the proper construction of the contract between the parties is that Kaufman retained to himself whatever dividend was declared in January, 1896, as the ordinary and usual fruit of the investment he was parting with. This he received when the cash dividend of 10 per cent. declared for the stockholders was paid to him. The stock dividend of 27 per cent. represented part of the corporate property sold to Hotopp, in which Kaufman reserved no interest, and was therefore not entitled to the whole or any part thereof." * * *

In the light of these authorities as well as of the circumstances surrounding the transaction, we think there can be no doubt but that the reservation of dividends on the stock pledged should be construed not to include the stock dividend, and that this should go, under the general principles of the law relating to pledges, as recognized in Maryland, to the first mortgage trustee as an essential part of the thing pledged with it. As was well said by the able special master in his report to the court below: "I think that, upon principle, and in view of the meaning of the word *dividend* in Maryland, where the first mortgage became effective, as well as generally elsewhere, and especially in the States of Virginia and North Carolina, under the laws of which Seaboard No. 1 was incorporated, the first mortgage trustee's position is sound. It will not do to say that this stock dividend represents *only* profits. It represents profits *automatically turned into stock*—stock which is not only capable of earnings far in excess of the ordinary return on investments, but which depletes to the extent of one-third the trustee's original holding. * * * By consenting to waive its dividends, it (the trustee) did not consent that the *principal* of its security should be impaired, save to the extent that the payment of cash dividends would necessarily reduce the assets of the R-W Co. It has never consented that the one-sixth stock interest pledged to it should be reduced, which reduction would automatically result from giving the stock dividend in question to the railway, or to its successors, the receivers, or to the refunding mortgage trustee." * * *

For the reasons stated, the decree appealed from will be modified by adding the amount of the dividend of December 31, 1930, $20,025, to the amount of the dividends which the receivers are ordered to pay over and deliver to the first mortgage trustee, * * *

Modified and affirmed.

SOPER, CIRCUIT JUDGE (dissenting). * * * We are told that the stock dividend does not fall within the terms of the contract because a stock dividend is not a true dividend. The leading authorities cited for the rule in the opinion of the court in the pending case are the well known decisions of Gibbons v. Mahon, 136 U.S. 549, 10 S.Ct. 1057, 34 L.Ed. 525, and Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521, 9 A.L.R. 1570. These decisions are based upon the logical theory that a stock dividend really takes nothing from the property of the corporation and adds nothing to the interest of the stockholders; that it is not a realization of profits by the stockholders but a transfer of surplus to capital so as to be no longer distributable; while an ordinary dividend is a distribution of profits which the corporation makes and the stockholder realizes. Moreover, it is said that the stock dividend in the pending case cannot fairly be described as a dividend payable to the Railroad Company within the meaning of the contract, because otherwise the interest of the Railroad Company in the Richmond-Washington Company, that originally amounted to a one-sixth interest, would be reduced to a one-ninth interest, and the security of the bondholders would be impaired.

These authorities and others like them, present the reasoning upon which is founded the so-called Massachusetts rule governing the ap-

portionment of dividends between life tenant and remainderman under a trust set up by a will or deed. This rule is that stock dividends, regardless of their source, are invariably treated as corpus, and cash dividends are classified as income. If it is applied by analogy to the facts of the pending case, we must hold that the stock dividend in question belongs to the trustee under the mortgage. But the Massachusetts rule, although favored in the federal courts and in other jurisdictions, is not recognized in the law of Maryland. By a long line of decisions of the Court of Appeals of Maryland, a different theory known as the Pennsylvania rule was firmly embedded in the law of the State when the mortgage under consideration was executed in 1900 and there remained until it was repealed by Chapter 580 of the Laws of Maryland of 1939. [Citing cases.] * * *

The Pennsylvania rule formerly prevailed in New York. It was analyzed by Cardozo, C. J. in Equitable Trust Co. v. Prentice, 250 N.Y. 1, 7, 164 N.E. 723, 63 A.L.R. 263, as follows: "The rule in this state was settled, until changed in 1926 as to subsequent trusts by an amendment of the statute * * * that as between life beneficiary and remainderman a stock dividend would be reckoned as principal or income according to the origin of the surplus out of which it was declared. To the extent that it distributed a surplus existing at the creation of the trust, it would be allocated to principal; to the extent that it distributed a surplus earned thereafter, it would be allocated to income. * * * The search in all these cases was to find the intention of the founder of the trust and then to give effect to it. What is income for a corporation may not be income for a shareholder. * * * What is principal for a shareholder, when taken in his own right, may be income, when held in trust to be divided among others. So, at least, the cases hold. The thought back of them is this: A surplus in the treasury of a corporation, even though not income for the shareholder, is potentially a fund that may be converted into income. The declaration of a stock dividend destroys this potential income, and turns the surplus into capital. The effect may be at times to thwart the plan of apportionment between life tenant and remainderman, as conceived at the foundation. A founder of a trust has conveyed shares to a trustee, to pay the income to wife or child for life, with remainder upon death to others. Did he mean in thus apportioning his estate that potential income might be cut down through the vote of the corporate managers, so that the beneficiary never could resort to it, and principal increased to the profit of remaindermen, perhaps unknown or unborn? We have thought that intention would be best promoted if the fund thus permanently diverted were included in a gift of income. Very likely the word 'dividend' has had a part in shaping the conclusion, for in their typical or common form dividends are income, like other recurrent gains (Lynch v. Hornby, 247 U.S. 339, 344, 38 S.Ct. 543, 62 L.Ed. 1149), and one steps readily into the assumption that the equivalence is absolute." * * *

If this rule is applied in the pending controversy, the stock dividend will go to the Railroad Company, for the source of the dividend was income of the Richmond-Washington Company that had accumulated

after the pledge of the stock was made, and the result will be that the Railroad Company will have the benefit of this income while the pledged stock remaining in the hands of the mortgage trustee will still be maintained at its original value. * * *

It is true that an award of the stock divided to the Railroad Company in this case would reduce the proportionate control held by the pledgee in the Richmond-Washington Company. But exactly the same impairment of the principal of a trust estate occurs when a stock dividend is given to the life tenant, and it cannot be that the rights of a pledgee are more sacred than those of a remainderman. The latter is sufficiently protected in the eye of the Maryland law if the value of the capital and accumulated surplus at the beginning of the trust is preserved in the principal of the trust estate. The same line of reasoning should govern us in our decision upon the pending appeal.

(2) PROPERTY DIVIDENDS

VENNER v. SOUTHERN PACIFIC CO.

Circuit Court of Appeals of the United States, Second Circuit, 1922. 279 F. 832.

Appeal from the District Court of the United States for the Southern District of New York. Suit in equity by Clarence H. Venner against the Southern Pacific Company and others. Decree for defendants, and complainant appeals.

The plaintiff is a citizen and resident of the city and state of New York. The defendant, the Southern Pacific Company, hereinafter called the Southern Company, is a corporation organized under the laws of the state of Kentucky. The plaintiff is the owner and holder of 200 shares of the capital stock of the Southern Company, of the par value of $100 each. The outstanding capital stock of the Southern Company is approximately $302,000,000, all common stock. The company also has outstanding approximately $45,539,000 of 5 per cent. bonds, which are convertible into stock at par.

The Pacific Oil Company, hereinafter called the Oil Company, also named as a defendant, is a corporation organized under the general corporation laws of the State of Delaware, with a capital stock of 3,500,000 shares, of no par value. The individual defendants are directors of one or both of the defendant corporations.

* * * Plaintiff commenced this action * * * on behalf of himself as a stockholder of the Southern Pacific Company, and on behalf of all other stockholders thereof, similarly situated, who may join with the plaintiff. * * * No other stockholder, however, has joined him in the suit. The suit grows out of the separation of the Southern Company's oil properties from its railroad properties, and the distribution of the former to its stockholders; such separation being necessary to enable the Southern Company to conform with the commodities clause (section 1) of the Hepburn Act, 34 Stat. 585,[18] and which makes it

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18 34 Stat. 585, 1906, § 1: "* * * From and after May first, nineteen hundred and eight, it shall be unlawful for any railroad company to transport from any

unlawful for any railroad company to transport in interstate commerce any article or commodity manufactured, mined, or produced by it, or under its authority, or which it may own in whole or in part, or in which it may have any interest, direct or indirect, except such articles or commodities as may be necessary and intended for its use in the conduct of its business as a common carrier.

The complaint attempts to set forth two causes of action—one by Venner directly against the two defendant corporations, to enjoin or rescind the separation and distribution above mentioned, depending upon whether or not the separation and distribution had been consummated; and the other a derivative suit by Venner, through the Southern Company, seeking to hold the other defendants liable to the Southern Company for any loss which it may have sustained by reason of the consummation of the plan for the separation and distribution of its oil properties. It appears that the Oil Company purchased the oil properties from the Southern Pacific Land Company, one of the Southern Company's subsidiaries, and that the consideration for the sale of the oil properties was paid in cash. The true facts are fully set forth in the circular letters sent by the Southern Company to the holders of its stock and convertible bonds.

Letters stated that the Oil Company would be organized under the laws of the state of Delaware with a capital stock of 3,500,000 shares, of no par value, for which the Southern Company would subscribe at $15 per share; that from the amount so realized, namely, $52,500,000, the Oil Company would purchase from the Southern Pacific Land Company for $43,750,000 about 259,000 acres of oil lands in California and 200,690 shares of the capital stock of the Associated Oil Company; that the entire capital stock of the Land Company is owned by the Southern Company, and that by the sale of these properties the Land Company would thus receive $43,750,000 in cash and the Oil Company would retain $8,750,000 as working capital; that the holders of the capital stock of the Southern Company, registered as such at the close of business on January 14, 1921, would be given the right to purchase at $15 per share, payment to be made therefor on or before March 1, 1921, one share of stock of the Oil Company for each share of the Southern Company's stock so held; that the stock of the Oil Company was fixed at 3,500,000 shares, to correspond as nearly as might be to the total number of shares of Southern Company's stock outstanding, together with the shares reserved for the conversion of its convertible bonds; that warrants would be issued to the stockholders as soon as possible after the closing of the books on January 14, 1921, specifying the amount of stock of the Oil Company which each stockholder was entitled to purchase; that on the back of the warrants would be two forms, one to be filled out and signed by the stockholder, if he desired to purchase the stock, and the other to be filled out and signed by the stockholder in case it was desired to dispose of the privilege of purchase; and, finally that all of the

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state * * * to any other state * * * any article or commodity, other than timber and the manufactured products thereof, manufactured, mined, or produced by it * * * or in which it may have any interest * * * except such articles or commodities as may be necessary and intended for its use in the conduct of its business as a common carrier. * * *"

warrants not returned to the treasurer of the Southern Company on or before March 1, 1921, with payment in full for the stock represented thereby, would be void and of no value.

The complaint also alleges that no stockholders' meeting of defendant Southern Company had been held or called for the purpose of authorizing or ratifying the plan, and that the plaintiff had not in any wise consented thereto, but, on the contrary, shortly after its promulgation, and after informing himself of the meaning and effect of same, he sent to the defendant company and its directors on the 10th day of December, 1920, a letter duly protesting against said plan and the action taken by the board of directors of the Southern Company in respect thereof, but the defendants refused to abandon said plan and insisted upon carrying the same into effect.

The complaint also alleges that the plaintiff is unwilling to subscribe to the stock of the said new corporation, to wit, the Oil Company, and unless he does so subscribe, in case the said proposed plan is carried into effect as intended, he will be deprived, as a stockholder of the defendant Southern Company, of all right and interest in or to certain property in which he is now a part owner as a stockholder of the Southern Company, and which property and the title to the same is to be wrongfully and illegally transferred from the said Southern Company, or its subsidiary, the Southern Pacific Land Company, to the Oil Company and to the stockholders thereof, and that the completion of the said proposed plan will deprive the plaintiff and other stockholders, who are unwilling to subscribe to the stock of the said new corporation, of his and their interest as stockholders in the Southern Company, in and to said property, by force against his and their will, without due process of law, and without adequate compensation therefor. It is alleged that the plan which the defendants have decided to consummate is unjust, illegal, and ultra vires.

An injunction is asked to restrain defendants from carrying their plan into effect, and that, in the event of the plan being consummated during the pendency of the action, a judgment may be entered, setting aside and declaring null and void all deeds of conveyance * * * of the property involved, and that the Oil Company be ordered to reconvey to the Southern Company * * * the said properties. * * *

ROGERS, Circuit Judge (after stating the facts as above). * * * This brings us to a consideration of the merits and whether the bill of complaint was properly dismissed on the ground that it fails to disclose a cause of action. The plaintiff asserts that the plan devised by the defendants is ultra vires, illegal, and void and on that ground he has brought this suit for rescission.

The plaintiff owns 200 shares, par value $100 each, of the capital stock of the Southern Company, which stock he acquired in 1916, and it is fully paid and nonassessable. He sues as such stockholder upon his own behalf, and on behalf of all other stockholders similarly situated, who may join with him and contribute to the expenses of the suit. No other stockholder, however, has joined in the suit. The fact that the plaintiff owns a relatively small amount of the stock and is the

only stockholder bringing the suit constitutes no reason why his rights should not be protected, if they are being illegally violated.

The Southern Company was not obliged by its charter or by any law to continue to hold and operate its oil properties. Its continued ownership or possession of those properties was not essential to its corporate life and business. Its disposal of them was not equivalent to a dissolution of the corporation, and did not work a frustration of the corporate enterprise. At the time the directors adopted "the plan to dispose of the oil properties, the Supreme Court had rendered its decision in United States v. Reading Co., 253 U.S. 26, 40 S.Ct. 425, 64 L.Ed. 760, and there was pending in that court the case of United States v. Lehigh Valley Railroad Co., 254 U.S. 255, 41 S.Ct. 104, 65 L.Ed. 253, the decision in which was handed down five days after the plan was adopted. Congress had adopted on June 29, 1906, the Hepburn Act (34 Stat. pt. 1, p. 585), containing the commodities clause, and it seemed to the directors to be a wise step to divorce its transportation business from its other enterprises, and that, as it could not develop its oil properties so long as it directly or indirectly owned them, it should dispose of them. It was therefore determined that they should be distributed to the stockholders.

But it was not feasible to distribute them in kind. It was thought best to organize the Oil Company as a means of facilitating the distribution. The plan was accordingly devised of fixing the capitalization of the new company at a figure which would give the stockholders of the Southern Company stock in the new company share for share. But it was concluded not to distribute to the stockholders the entire value of the oil properties, but that a portion of the value should be retained by the Southern Company and that only the excess over $43,750,000 should be distributed to the stockholders. As it was, however, desirable to separate entirely the oil properties from the transportation properties, it was decided that the Southern Company should not itself retain any portion of the Oil Company's stock, but should instead distribute all of the stock and charge the stockholders a portion of its value. They proposed, therefore, to offer the stock to their stockholders at $15 per share. The question of whether the plan decided was ultra vires does not depend upon whether it was wise or unwise, but in passing we may point out that, out of more than 3,000,000 shares, the plaintiff, holding 200 shares, is the sole dissenter who objects or assails the validity of what the directors adopted.

When a business corporation possesses a surplus in excess of the amount of its capital, the directors in their discretion may distribute it among the stockholders in proportion to their shares, and the fund so distributed is a "dividend." This discretion of the directors is subject to certain restrictions, so that no discrimination can be made between the stockholders in the mode of distribution agreed upon. But the discretion is unrestricted as to whether the distribution shall be made in cash, or in bonds, or in property, and under some circumstances in stock. Whether the directors shall sell the property, thereby converting it into cash, and make the dividend payable in cash, is a matter solely within their discretion; and in the particular case now

before the court they decided not to sell the property. If the corporation has stock in reserve, which it has not yet disposed of, or if it has the right under its charter to increase its capital stock, it is clear that the distribution may be made by means of a stock dividend.

In this case the charter gave the corporation, as already stated, the power to acquire stock in any then existing corporation, or in one thereafter formed, and to deal in all kinds of stock "in such manner as may * * * be determined by the directors of said corporation." In the exercise of that discretion it was decided that a new corporation should be formed to hold the oil properties, which should be transferred to it, and that the shares of its stock, representing the property transferred should be distributed among the stockholders of the Southern Company. We are unable to see why, under the broad powers expressly conferred upon the directors of that company, that method of distribution of the property among the stockholders was not within the discretion of the governing body, the directors.

When the directors came to the conclusion that the best interests of the Southern Company required that its oil properties should be segregated and disposed of, they were at liberty to accomplish that result by a sale of the properties to third persons; but there certainly was nothing in the company's charter which made procedure by way of sale compulsory. It was for the directors, under the powers which the charter gave them to determine whether it was desirable to adopt that method or some other. They might very well have concluded that a sufficient number of potential purchasers could not be found to make it probable that the company would receive full value for the properties which the plaintiff claims were worth at least $143,750,000. For that or some other reason which seemed to them sufficient they chose not to proceed by way of sale.

So they might have decided to accomplish the segregation and disposal of the properties by making an absolute gift of the whole of them to the stockholders. But for reasons which it is not within the province of this court to review they did not decide to adopt that method. But they concluded that it would promote the best interests of the Southern Company that it should receive something for the properties which it was proposed to turn over to the stockholders in the manner finally decided upon. The properties to be parted with not being divisible in kind, they decided to keep them together by a transfer to a corporation organized for the purpose and distributed through the stock of such corporation and that the stock should be offered to all the stockholders of the Southern Company pro rata, and on such terms as not to operate oppressively or unequally.

The directors therefore gave to holders of stock of the Southern Company the right to purchase at $15 per share, one share of stock of the new company for each share of Southern Company stock held at the close of business on January 14, 1921, and registered on the books of the company at that time. It placed the stockholder in a position where it was necessary for him to do one of two things to benefit himself or avoid a loss: (1) Buy the stock of the new company at $15 a share, the stock being worth much more than the price at which it

was offered; or (2) sell his right to buy such stock. If the stockholder should refuse either to buy or to sell his right to buy, and should consequently suffer a loss in the lessened value of his Southern Company's stock, the loss would be self-imposed, and would not properly be attributable to the action of the directors.

To say that this plan practically amounted to selling a man what already belonged to him is, of course, quite unwarranted, and is based on a misconception of the law. That a stockholder as such is not the owner of any part of the corporate property is so well established in the law as to need no citation of authorities to support it.

The complaint alleged that no stockholders' meeting of the Southern Company was held or called for the purpose of authorizing or ratifying the plan which the directors adopted for the transfer of the properties. But no action by the stockholders was necessary. It is quite true that the directors of a corporation cannot as a rule unless authorized to do so by the shareholders, sell out en masse all its property, and thus put an end to its business and defeat the objects of its creation. Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 596, 41 S.Ct. 209, 65 L.Ed. 425; Chicago City Railway Co. v. Allerton, 18 Wall. 233, 21 L.Ed. 902; Rollins v. Clay, 33 Me. 132. But they have, of course, even such power where it is conferred upon them by the charter or by statute. St. Louis v. St. Louis Gaslight Co., 70 Mo. 69. In the charter of the Southern Company it was expressly provided that the corporation might sell "all kinds of personal and real property to such amount as the directors * * * may determine." We need not inquire whether this would have justified the directors, without authority from the shareholders, in selling out all property of the Southern Company, or such properties as were essential to its corporate life and business. It is enough that the authority conferred was certainly broad enough to warrant the sale of its oil properties, which were not essential to its corporate life and would not bring about an abandonment of the corporate enterprise.

It cannot be claimed that the Southern Company could not lawfully acquire the stock of the Oil Company. The right of one corporation to acquire the stock of another corporation is a question about which a difference of opinion has existed in the courts; but there is no difference of opinion on the question when the charter of the corporation itself expressly authorized it to do so, and such authority is found in the charter of the Southern Company which declares that it may acquire by purchase or otherwise the stocks and securities of that corporation.

Then it is said that the Southern Company could not transfer the oil properties for stock which it purposed to distribute among the stockholders but that the transfer should have been made for money only, for the reason that a stockholder may not lawfully be compelled to accept a change of investment made for him by others or to elect between losing his interest or entering a new company. This question is discussed in Geddes v. Anaconda Copper Mining Co., supra, in a case where all the property of the corporation was sold for the stock without the approval of the stockholders. It did not appear in that case, as it does in this, that the company was expressly authorized to ac-

quire the stock of other corporations. In referring to the rule that the sale of all the assets should be for money only, and that stockholders should not be compelled to accept a change of investment made for them by others, the Supreme Court said:

"But it has been suggested that this rule, also, should be subject to the exception that, when stock which has an established market value is taken in exchange for corporation property, it should be treated as the equivalent of money, and that a sale otherwise valid should be sustained. Noyes, Incorporate Relations, § 120, and cases cited. We approve the soundness of such an exception. It would be a reproach to the law to invalidate a sale otherwise valid, because not made for money, when it is made for stock which a stockholder receiving it may at once, in the New York or other general market, convert into an adequate cash consideration for what his holdings were in the corporate property." 254 U.S. 598, 41 S.Ct. 209, 212, 65 L.Ed. 425.

Courts may take judicial notice of facts of common knowledge and of well-known financial conditions. We are entitled to take notice of the marketability of certain stocks and the practical equivalence of such stocks to cash; and after the action taken by directors of the Southern Company, giving to its stockholders the right to acquire one share of the new stock for each share of the Southern Company stock held by him upon payment of $15, or, if he preferred, the right to assign to another his privilege of purchase, those rights to the public knowledge have been dealt with on the New York Stock Exchange and the New York curb, and have enjoyed a broad and active market. If a stockholder did not desire to take advantage of his right to acquire the new stock, he had a market where he could realize upon his right and in effect receive his proportionate distributive share of the assets transferred to the Oil Company.

The suit shows that a difference of opinion exists between the single stockholder, who brings this suit, and the directors, as to whether the oil properties of the Southern Company should have been segregated together and disposed of at all, or as to whether the entire value of those properties should have been given outright to the stockholders, without anything in the way of compensation to the Southern Company for the loss by it of the revenues consequent upon the transfer of the properties. The judgment of the complaining stockholder is not to be substituted for the judgment of the directors in respect to any such matters, which rested exclusively in the discretion of the directors. It does not seem to us that the directors in anything they have done have violated any legal right possessed by the complaining stockholder.

In Ellerman v. Chicago Junction Railways & Union Stockyards Co., 49 N.J.Eq. 217, 23 A. 287, which was a suit by stockholders to enjoin as ultra vires the execution of an agreement entered into by directors, the court said:

"Individual stockholders cannot question, in judicial proceedings, the corporate acts of directors, if the same are within the powers of the corporation, and, in furtherance of its purposes, are not unlawful or against good morals, and are done in good faith and in the exercise of an honest judgment. Questions of policy of management, of exped-

iency of contracts or action, of adequacy of consideration not grossly disproportionate, of lawful appropriation of corporate funds to advance corporate interests, are left solely to the honest decision of the directors, if their powers are without limitation or free from restraint. To hold otherwise would be to substitute the judgment and discretion of others in the place of those determined on by the scheme of incorporation."

We may also add that it is well settled that, in the absence of usurpation, of fraud, or of gross negligence, courts of equity do not interfere, at the suit of a dissatisfied stockholder merely to overrule or control the discretion of the directors on questions of corporate management or policy. 14 A.C.J. 84; Burden v. Burden, 159 N.Y. 287, 54 N.E. 17; Figge v. Bergenthal, 130 Wis. 594, 109 N.W. 581, 110 N.W. 798. Within the limits of their authority the directors possess full discretionary power. Post v. Buck's Stove & Range Co., 200 F. 918, 119 C.C.A. 214, 43 L.R.A.,N.S., 498.

We do not find in the action complained of that the directors have acted in excess of the powers given them in the charter, or that they have committed any breach of their trust.

Decree affirmed.[19]

BENAS v. TITLE GUARANTY TRUST COMPANY.

St. Louis Court of Appeals of Missouri, 1924. 216 Mo.App. 53, 267 S.W. 28.

Action by George Benas against the Title Guaranty Trust Company. Judgment for defendant, and plaintiff appeals. Affirmed.

SUTTON, C. This is an action at law. A jury was waived and trial was had before the court, resulting in a judgment in favor of defendant. Plaintiff appeals.

Appellant, a stockholder in respondent company, sued to recover a money judgment for $3,200 against respondent for that it had failed and refused to distribute to him his share of a dividend declared by the respondent.

On March 17, 1915, the board of directors of respondent passed the following resolution, to wit:

"Whereas, a meeting of the stockholders of the Title Guaranty Company is to be held April 13, 1915, for the purpose of reducing the capital stock from $2,500,000 to $1,000,000; and

"Whereas, it is deemed best to declare a dividend of American Trust Company stock to holders of Title Guaranty Trust Company stock, provided the capital stock is reduced as proposed from $2,500,000 to $1,000,000:

"Now, therefore, it is resolved, that a dividend consisting of the shares of the American Trust Company stock be declared and be distributed after the 13th day of April, 1915, provided the stock of said Title Guaranty Trust Company has been reduced from $2,500,000 to $1,000,000."

[19] Certiorari denied, 258 U.S. 628, 42 S.Ct. 461, 66 L.Ed. 799, 1921.

Thereafter, on April 13, 1915, the stockholders passed an appropriate resolution for reducing the capital stock from $2,500,000 to $1,000,-000. This reduction in capital stock became effective under the Missouri statute on the 20th day of April, 1915, being the date upon which a duly certified copy of a statement of the proceedings for such reduction was filed in the office of the bank commissioner of the state of Missouri.

Prior to the reduction of the capital stock, the actual value of the total assets of the respondent did not exceed the sum of $2,196,534.69. Among these assets was all the outstanding stock of the American Trust Company of the actual value of $1,147,000. The total liabilities of respondent were $2,887,182.94, consisting of capital stock liability of $2,500,000 and indebtedness of $387,182.94. Respondent had no surplus, but there existed a deficit of at least $690,648.25. After the reduction of the capital stock, the surplus did not exceed the sum of $809,351.75, and the distribution of the American Trust Company stock as a dividend to respondent's stockholders would have impaired its capital in at least the sum of $337,648.25.

On April 14, 1915, which was six days before the reduction in capital stock became effective, the board of directors of the respondent company passed the following resolution:

"Whereas, a resolution was adopted at the meeting of the board of date March 17, 1915, looking to a distribution of the stock of the American Trust Company after April 13, 1915; and

"Whereas, it is the sense of the board that the time is not now propitious for such distribution, and that it will not be to the interest of the company or its stockholders that such distribution be made:

"Therefore, be it resolved, that no action be taken upon said resolution, that no stock dividend be declared at this time, and said resolution be and the same is hereby rescinded."

None of the stock of the American Trust Company was distributed to respondent's stockholders.

Appellant, as one of the stockholders, made demand upon respondent to deliver to him 26 shares of the American Trust Company stock, which it is conceded was his share of the dividend as declared by the board; but said demand was refused, and appellant brought this suit to recover the value of said 26 shares.

The appellant contends that the declaration of the dividend made on the 13th day of March, 1915, was valid and conclusive, and that its subsequent rescission by the board of directors was unauthorized, and that he is entitled as a matter of law to recover the value of his share of the dividend declared; whereas, the respondent contends that the declaration was ultra vires and void because it undertook to distribute capital in the guise of a dividend, and that the subsequent rescission of the declaration by the board was proper and removed any possible basis of a valid claim by appellant against respondent on account of said declaration.

That under the statutes of this state, it is beyond the power of a corporation such as respondent to declare and distribute dividends out of its capital cannot be questioned. Sections 1132, 1137, 1138, and 1139, R. S. 1909; sections 11825, 11826, 11827, and 11828, R. S. 1919.

Independent of statutory provision, however, it is a fundamental rule that a corporation has no power to make dividends out of capital, but may lawfully declare dividends only out of surplus or profits over and above its capital. It is a corollary to this rule that if a dividend is declared the distribution of which would impair the capital of the corporation, such ultra vires declaration may be subsequently reconsidered and rescinded. [Citing cases] * * *

All this in no way contravenes the familiar rule that a lawful declaration of a dividend out of existing surplus or profits available for that purpose creates a debt against the corporation and in favor of each stockholder for his share of the dividend, and that such declaration may not be rescinded by any subsequent action of the corporation without the consent of the stockholder concerned, as a debtor may not rescind his debt without the consent of his creditor. McLaran v. Planing Mill Co., 117 Mo.App. 40, 93 S.W. 819; Ball v. Cotton Press Co., 141 Mo.App. 26, loc.cit. 42, 121 S.W. 798; Hope Lumber Co. v. Stewart (Mo.App.) 241 S.W. 675. Nor is the rule questioned that a surplus arising from a lawful reduction of the capital stock is available for dividend purposes and may be lawfully distributed as such. [Citing cases.] * * *

In this case the court found upon very substantial evidence that prior to the reduction of its capital stock the actual value of the total assets of the respondent was not more than $2,196,534.69, and that its total liabilities, including its stock liability, amounted to $2,887,182.94, resulting in a deficit or impairment of its capital stock in at least the sum of $690,648.25. Hence the reduction of the capital stock created an actual surplus of only $809,351.75. The evidence further showed, and the court found that the shares of the American Trust Company stock proposed to be distributed as a dividend were of the actual value of $1,147,000. So that the distribution of these shares as a dividend, pursuant to the declaration of the board, would have resulted in the impairment of respondent's capital stock, as reduced, to the amount of $337,648.25. The subsequent rescission of such declaration was therefore not only within the power of the board, but was eminently proper.

The value of respondent's assets, however, as carried on the books of the company and set forth in its statement of the proceedings for the reduction of its capital stock, was such as to show a surplus amply sufficient for the distribution of the dividend declared by the board without any impairment of the capital stock as reduced. The appellant's counsel insist that the books of respondent and its statement of proceedings for the reduction of its capital stock are conclusively determinative of the value of its assets and may not be contradicted or impeached by parol evidence, and assigns as error the admission of parol evidence over his objection to show the actual value of the assets.

Respondent's counsel take the contrary view, which they express in the following language:

"If appellant's theory is correct, namely, that on the question of the validity of dividends the corporation is conclusively bound by the value of its assets as shown upon the books of the company or by documents prepared by its officers, then the law against the declaration of a divi-

dend when there is no surplus or profits might just as well be stricken from the books, because, if appellant's theory is correct, the directors, while they have no power to declare dividends except out of surplus or profits, could easily give themselves power of declaring dividends in the absence of profits, by placing on the books of the company or in documents signed by its officers, either by mistake or otherwise, false values of its assets. The mere statement of the consequences of such a rule is sufficient to show that the rule cannot and does not exist."

This view, we think, is supported upon both principle and authority. [Citing cases.] * * *

In the Siegman Case it is said by the court, speaking through Pitney, J., that while it is a function of the directors of a corporation to determine whether net earnings or surplus exist applicable to the payment of dividends, they cannot, by an erroneous determination of this point, confer either upon themselves or upon the corporation the power to make dividends out of capital. Just this the directors of a corporation may do, if the courts are not permitted to go behind the values of its assets, as written, or caused to be written, by such directors themselves, in the books and documents of the corporation.

Appellant cites and relies on a number of cases wherein corporations were denied the right to contradict or impeach their own records. [Citing cases.] * * *

These cases are clearly distinguishable from the instant case upon their facts and the principles involved in them, and it is obvious without discussion that they lend no sanction to the proposition that the directors of a corporation may confer upon themselves or the corporation power to do that which the law forbids, that is, to declare and distribute a dividend out of its capital, by the very simple and easy process of writing into its books and documents fictitious values of its assets.

The Commissioner recommends that the judgment of the circuit court be affirmed.

PER CURIAM. The foregoing opinion of SUTTON, C., is adopted as the opinion of the court.

The judgment of the circuit court is, accordingly, affirmed.

4. LIABILITY FOR WRONGFUL DECLARATION

NEW YORK PENAL LAW

§ 664. *Misconduct of officers and directors of stock corporations.* A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended:

1. To make a dividend, except from surplus, and in the cases and manner allowed by law; or,

2. To divide, withdraw, or in any manner pay to the stockholders, or any of them, except as provided or permitted by law, any part of the capital stock of the corporation; or to reduce such capital stock without the consent of the legislature; or, * * *

5. To apply any portion of the funds of such corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock, except as provided or permitted by law.

Is guilty of a misdemeanor.

CORNELL v. SEDDINGER et al.

Supreme Court of Pennsylvania, 1912. 237 Pa. 389, 85 A. 446.

Suit by Howard E. Cornell, as receiver of the Neafie & Levy Ship & Engine Building Company, and others, against Mathias Seddinger and others. Judgment for defendants, and plaintiff appeals. Reversed.

POTTER, J. This was a bill in equity filed by Howard E. Cornell, receiver of the Neafie & Levy Ship & Engine Building Company, Penn Works, Philadelphia, against Mathias Seddinger, John H. Watt, Eli Kirk Price, Somers N. Smith, and Laurence B. Levy, administrator of Edmund L. Levy, deceased. The purpose of the bill was to compel the defendants to repay to the company certain sums which it was alleged the defendants, as directors had wrongfully declared as dividends, when as a matter of fact there were no profits to divide, and the so-called dividends were paid out of capital. * * *

The dividends which are here in question were declared by the directors as follows: On November 25, 1901, one of 3½ per cent., $28,000. On April 2, 1902, one of 6 per cent., $48,000. On March 30, 1903, one of 6 per cent., $48,000. These dividends were in each case paid shortly after they were declared. During the period from 1900 to 1904, the company was engaged in building three torpedo boat destroyers, and a cruiser for the United States government, and the business was carried on at a loss. The original capital of $800,000 was largely impaired, being depleted by a sum in excess of $760,000, leaving only a nominal amount. The dividends above referred to were paid, not out of profits, but out of capital. In placing the responsibility for this action upon the directors, the trial judge distinguished between the directors Seddinger and Smith, who were executive officers of the company, and the other three directors, Price, Levy, and Watt, and held that the former were liable for the amount of the dividends improperly declared and paid, but the other three he relieved from responsibility, and directed that as to them the bill be dismissed. Whether or not he was correct in making this distinction is the important question raised by this appeal. * * *

It may be regarded as settled law that directors of a corporation are trustees or quasi trustees of the capital of the company, and liable as trustees for any breach of duty with respect to the application of it. The capital of a company may not lawfully be used for the payment of dividends. It was so used in the present case. At whose instance and direction was this done? Obviously by the board of directors. But, says the learned chancellor, three of the members of the board were not practical shipbuilders, or were not personally familiar with the processes of construction, and therefore they were excusable for accepting the reports at their face value, without further inquiry.

We are not able to accept this theory as applicable to the facts of the present case. No special knowledge of the details of shipbuilding was required in order to determine whether or not a dividend might properly be declared. Certain reports of the treasurer were presented to the directors at the meeting of the board. These reports were made up by the treasurer partly from the books and partly from information from the executive officers as to the inventories of stock on hand, work in progress, etc. These items included very large amounts which were not available as assets in any proper sense of the word, as a basis for the declaration of dividends. * * *

Inflations of various kinds which were in existence, of so glaring a nature that any fairly competent man, who paid any attention to the make-up of the items appearing upon the face of the reports, would have found that, instead of apparent profits there was in reality an impairment of the capital.

The defense of Directors Price, Watt, and Levy was that they relied upon the face of the reports of the treasurer, as showing profits, without making any inquiry as to the nature of the items reported as available assets. Directors can hardly be regarded as discharging their duty, and protecting the trust imposed upon them, when they accept a report which upon its face calls for explanation and analysis, and after a glance at it, to see that it purports to show profits, proceed without further investigation to declare dividends. Yet it is admitted that this is practically what was done. Nor was the general condition of the company such as to blunt the senses of the directors to the need of scrutinizing the reports. The minutes show that, at the time these various dividends were declared, there was a shortage of working capital, and the directors were considering the necessity of borrowing money, both upon notes and by mortgaging the real estate.

It is admitted that two of the directors had personal knowledge of the real condition of the company, and, after a careful examination of the evidence, we cannot avoid the conclusion that the other directors might, by the exercise of common prudence, have readily ascertained the worthless character of much that was carried upon the reports of the treasurer as assets. As well might a board include the expense account of a corporation as a basis for dividends, as that which was reckoned by this board as part of the assets of the company. As a matter of course, any such account must be deducted from the apparent profits before a basis for considering the declaration of a dividend can be reached. The failure of the directors to investigate the character of the items of the report led them to declare dividends when there was no surplus or profits to divide. This action was not merely an error of judgment, but was the result of lack of attention to the real condition of the company. Mere ignorance of facts which they could easily have ascertained cannot excuse them for the performance of illegal acts, in declaring dividends out of capital. It was the duty of the directors to inform themselves as to the actual condition of the company before declaring dividends. If they had made full inquiry and reasonable examination, and had been misled by erroneous information on which they had the right to rely, that might have served as an ex-

cuse for distributing capital instead of profits. But nothing of the kind appears from the evidence.

The bill in this case was not filed to secure payment by the directors of the debts of the corporation, but its purpose was to compel the directors to replace funds of the company which they wrongfully paid out as dividends. It is suggested in the argument of counsel for appellee Price that the report of the receiver showed that the assets exceeded the liabilities when the company passed into the hands of the receiver. An inspection of this report shows, however, that in making it up the capital stock was not taken into consideration as a liability.

The first assignment of error is sustained, and the decree of the court below is reversed, in so far as it directs the dismissal of the bill of complaint against John H. Watt and Eli Kirk Price and Laurence B. Levy, as administrator of the estate of E. L. Levy, deceased. It is adjudged that all the directors by their conduct rendered themselves jointly and severally liable under the terms of the bill, and the plaintiff is entitled to the same relief with respect to all of the defendants as was extended to him with respect to the defendants Seddinger and Smith. It is further ordered that the record be remitted to the court below, in order that a decree may be entered in accordance with this opinion.

APPLETON et al. v. AMERICAN MALTING COMPANY et al.

Court of Errors and Appeals of New Jersey, 1903. 65 N.J.Eq. 375, 54 A. 454.

Suit by Aaron Appleton and another against the American Malting Company and others. From a decree sustaining demurrers to and dismissing the bill, complainants appeal. Reversed.

GUMMERE, C. J. The appellants, who are stockholders of the defendant company, filed their bill to compel the directors of the company, who held office as such from the time of the organization of the company in September, 1897, up to and including the year 1899, to pay back into the treasury of the company certain dividends paid out by them during the period named from the capital stock of the company, in violation of the provisions of section 30 of the corporation act. The bill was filed by the complainants, not in the assertion of any individual right, but on behalf of the company. Each of the defendants filed a demurrer to the bill, and upon a hearing in the court below a decree was entered sustaining the demurrers and dismissing the bill. From that decree this appeal was taken.

Two questions are raised by the demurrers: First. Do the facts exhibited in the bill justify the complainants in instituting this suit without first making demand upon the directors to do so? Second. Does the thirtieth section of the corporation act impose any liability upon directors who have paid dividends out of capital, except in the event of the dissolution or the insolvency of the company? * * *

Concluding that the facts stated in the bill sufficiently show the right of the complainants to maintain this suit upon behalf of the corporation, we reach the meritorious question raised by the demurrer, and that is whether, by virtue of the provisions of the thirtieth section

of the corporation act, the directors who have participated in the declaration and payment of a dividend out of capital are liable to the corporation for so doing, except in case of the dissolution or insolvency of the company. The language of the statute is as follows: "No corporation shall make dividends, except from the surplus or net profits arising from its business, nor divide, withdraw, or in any way pay to the stockholders, or any of them, any part of its capital stock, or reduce its capital stock, except according to this act, and in case of any violation of the provisions of this section, the directors under whose administration the same may happen shall be jointly and severally liable, at any time within six years after paying such dividend, to the corporation and to its creditors, in the event of its dissolution or insolvency, to the full amount of the dividend made or capital stock so divided, withdrawn, paid out or reduced, with interest on the same from the time such liability accrued: provided, that any director who may have been absent when the same was done or who may have dissented from the act or resolution by which the same was done, may exonerate himself from such liability by causing his dissent to be entered at large on the minutes of the directors, at the time the same was done, or forthwith after he shall have notice of the same, and by causing a true copy of said dissent to be published, within two weeks after the same shall have been so entered, in a newspaper published in the county where the corporation has its principal office." The contention of the demurrants, which was sustained by the Court of Chancery, is that the remedy provided by the statute is solely for the benefit of creditors; and that it can only be availed of in case of the insolvency of the corporation. The argument is that the punctuation (the insertion of a comma, after the word "creditors") shows clearly that this was intended by the Legislature to be a winding-up provision, creating a fund for the payment of debts; and that, even if the location of the comma is not to be accepted as controlling, nevertheless a construction which would enable the corporation to compel the directors, for the benefit of its stockholders, to make good a deficit in the capital stock, when the stockholders themselves already had in their pockets the whole amount of that deficit, is so unreasonable and inequitable as to require its rejection. Punctuation, although usually considered in discovering the purpose of a statute, is never decisive in determining it; on the contrary, it will be entirely disregarded if it be necessary to do so in order to arrive at the real meaning and intent of the lawmakers. * * *

Reading the statute without regard to punctuation, the Legislature has declared that for the impairment of the capital of the company "the directors shall be jointly and severally liable at any time within six years to the corporation and to its creditors in the event of its dissolution or insolvency to the full amount of the capital stock so divided withdrawn paid out or reduced." The apparent object of the provision is to afford protection equally to the corporation and to its creditors against loss by reason of the illegal act. But the creditors can suffer no injury from it unless the capital is so impaired as to render the company insolvent. Not so with the corporation. Any impairment of its capital is harmful to it in some degree; the seriousness

of the injury depending upon the extent of the impairment. For the full protection of the company the liability of the directors must be absolute. No liability on the part of the directors is required for the full protection of creditors, except in case of the insolvency of the corporation, or possibly in the event of its voluntary liquidation. The words of the statute give this full measure of protection. For disobedience of its mandate "the directors shall be jointly and severally liable to the corporation, and to its creditors in the event of its dissolution or insolvency"; to the corporation in any event, to the creditors in the event expressed in the statute. In our judgment, the Legislature intended by this provision to afford the full measure of protection which the words provide.

It is argued by the demurrants, as has been already stated, that the statute, so construed, is grossly unjust and inequitable, in that it requires the directors to pay into the treasury of the corporation, for the benefit of the stockholders, the amount of the deficit, although the stockholders, not the directors, have in their pockets the portion of the capital which has been withdrawn. The argument assumes that there will be no transfer of the stock of the company during the period of the liability of the directors. The assumption is unwarranted. The very declaration of the dividend, evidencing as it does the apparent prosperity of the company, creates a desire on the part of outsiders to become holders of the stock. It at the same time decreases the actual, while increasing the apparent, value of the stock. The result is to afford unscrupulous directors, and stockholders who are cognizant of the illegal action of the board, an opportunity to unload their holdings upon innocent purchasers at fraudulently inflated prices. It is eminently just that the persons whose wrongful act has caused loss to those who have been induced by it to become stockholders should make good that loss. Nor is it inequitable that stockholders who have innocently participated in the distribution of the illegal dividends should have their stock restored to its normal value by contribution from the directors who have impaired the capital without being first required to pay back the dividend so paid to them. The ordinary purchaser of corporate stock holds it as an investment. He rightly considers and treats the dividends paid upon it as income. In many instances the income is required to meet the expenses of living, and is entirely expended for that purpose. To say that a person who has been unwittingly induced to exhaust his principal by the mistaken or fraudulent representation of those to whom he has intrusted it that what has been paid to him is income suffers no injury is absurd. To refuse him redress except upon condition that he return the moneys which he has expended in the belief that his capital was intact, notwithstanding that by such expenditure he is rendered penniless, is to put a premium upon fraud in corporate management.

The learned vice chancellor, who heard the case in the court below, considered that, if the statute fixed liability upon the directors without regard to the financial condition or needs of the corporation, then it was highly penal in its character, and that for this reason a court of equity should refuse to entertain a suit for its enforcement. In our

opinion, the liability imposed by the statute is not penal in its character. Its sole purpose is, not to punish, but to provide for the making of compensation by wrongdoers for the injury sustained by their wrongful act.

The decree appealed from should be reversed.

BRANCH v. KAISER et al.

Supreme Court of Pennsylvania, 1928. 291 Pa. 543, 140 A. 498.

Bill in equity by Clayton G. Branch, trustee in bankruptcy of the Girard Grocery Company, against Albert Kaiser and others. Decree for plaintiff, and defendants appeal. Affirmed.

FRAZER, J. Defendants appealed from a decree entered by the court below on a bill in equity, filed by a trustee in bankruptcy, to compel repayment by respondents of moneys paid out as dividends alleged to have been wrongfully declared by the directors of the bankrupt corporation. Hearing was had in the court below by the court in banc on bill and answer.

The corporation in question, known as the Girard Grocery Company, was incorporated in 1908 under the laws of this commonwealth, for the purpose of carrying on a wholesale business principally in groceries and food products. The stockholders were confined to retail grocers to whom the company sold goods, the business accordingly being carried on in the nature of a co-operative organization. The original capital was $175,000, later increased to $1,000,000, divided into 10,000 shares of $100 each, of which there was issued and outstanding at the time of the bankrupt proceedings, stock to the aggregate value of $441,800. The business was prosperous from the start and by the year 1920 the corporation had accumulated a surplus of assets over liabilities of approximately $171,000, and for a number of years, up to 1920, had declared and paid dividends. In that year, however, it met with financial disaster, suffering a loss of $1,000,000, due, as claimed by respondents and admitted by the trustee, not to mismanagement, neglect, or wrongful practices on the part of the directors, but to a condition in the market for certain commodities, chiefly sugar and food products, which to supply the demands of customers, it had bought outright and contracted for future deliveries, at the then prevalent high prices, but these suddenly enormously slumped, particularly sugar, large quantities of which the company had bargained for, in addition to immediate purchases, at prices ranging from 26 to 28 cents a pound, and which suddenly dropped to as low as 5½ cents a pound, entailing in this one item a loss of $500,000. A similar amount was lost on purchases of food products. This occurrence culminated during the fiscal year of the company between July 1, 1920, and June 30, 1921. It was a post war condition in the market which the directors could neither foresee nor prevent.

From inception of the corporation to its bankruptcy in 1926, the respondents were continuously directors of the corporation, Kaiser being also president and Schoch holding the office of secretary.

It is averred in the bill of complaint, and not denied in the answer of defendants, that as a result of the $1,000,000 loss in 1920 the corporation became in fact insolvent and the capital wholly or in part impaired and dissipated. Up to 1920 the affairs of the company had been carried on prosperously, and the heavy loss of that year was in nowise attributable to neglect, mismanagement, or illegal practices on the part of the directors. At this point respondents who had the active management and control of the business, committed error disastrous to them in every respect. Instead of acquainting the stockholders with the actual unstable financial condition of the corporation, for which they were blameless, facing the publicity of the unquestioned insolvency, of which they certainly had knowledge, and setting about for a legal adjustment of affairs, they deliberately adopted and put into practice a bold and reprehensible system of deception, designed to conceal the insolvency from the stockholders and the public with the expectation of recouping, by means of future business, the loss of the $1,000,000, and thereby again place the company upon a sound financial standing. The situation was desperate, of course. There was practically no longer a surplus and a manifest impairment of capital existed.

Respondents exercised practically exclusive supervision over and management of the company's business and financial transactions, and in this situation appear to have experienced no difficulty in putting into effect their plans for an effective concealment of the loss of 1920 and to enable the company, as they hoped, to emerge financially rehabilitated from its troubles. These plans included false overvaluation of assets, refraining from notice of the $1,000,000 loss in their reports, a presentation of false annual statements, and a diversion into dividends of profits that should have been applied to lessening the capital's impairment. A summary of these practices will show the extent and method of their operations. Beginning with the close of the fiscal year of 1921, they made no record in the company's books of the $1,000,000 loss, gave no notice of it in their annual report, and merely noted in that report a deficit of $22,756.87. In addition, they presented inflated inventory sheets, giving to the actual merchandise the company had on hand a cost valuation, when in fact the value had enormously decreased. The same methods of concealment, misrepresentation, and fictitious inventories were continued during the years down to and including 1925.

These methods and practices, as set forth in detail in the bill, are frankly admitted in respondents' answer, with the explanation, or excuse, that "the increase in the item of inventory was made with the intent and purpose of carrying on the business of the said Girard Grocery Company for the benefit of its stockholders." It is doubtless true that such was the actuating motive impelling respondents to resort to their fraudulent misrepresentations and concealments; it was, however, a practice which safe and honest business methods will not support and which the law will not tolerate. Where acts of directors are of such nature that they directly and primarily affect the interests of stockholders in their shares of stock, by diminishing their value or otherwise injuring their rights, then the stockholders

may sue to redress the wrong. Thompson on Corporations, § 1313.

Respondents in the present case, did not stop with these deceiving representations and false inventories; a situation additional to these was necessary to sustain appearance of solvency. Something of a more tangible and satisfying nature was necessary to hold down suspicion and prevent possible investigation. There still remained unused an exceptionally effective proceeding for that purpose—that of declaring and paying dividends. The expectation of respondents that there would be profits made by the company after the loss in 1920 was not unfounded. Profits were realized, and in 1922 while still concealing the corporation's loss, and continuing the inflating of inventories and furnishing falsifying statements, with the organization in actual insolvency, a meeting of the directors was held, attended by respondents, at which a dividend was declared, followed by similar action in the succeeding years, down to and including 1925, the total amount thus paid out in dividends being in excess of $132,000. The payments of these annual allotments, out of current profits, is admitted by respondents and justified by them on the ground that in the years of the payments, profits were realized from the business of the company and that the distributions were made out of profits accruing after the insolvency of 1920.

Nowhere in the record does it appear that the total of these profits, which respondents claim was in excess of the total of the dividends paid out, would have materially lessened the existing impairment of the capital had they been so applied. Nevertheless, the only proper and rightful use of these several amounts was to apply them, so far as they went, to the reduction of that deficit, and hence their application to the payment of dividends was under the situation, clearly unjustifiable and illegal. There were in fact no profits or surplus, out of which alone dividends could be declared, available to these respondents for use as distribution payments. "Surplus" or "profits" denote an excess in the aggregate value of all assets of a corporation over the sum of its entire liabilities, including capital stock. Edwards v. Douglas, 269 U.S. 204, 46 S.Ct. 85, 70 L.Ed. 235. Clearly, in the present case the profits made, totaling over $132,000, were not sufficient to constitute a surplus over the sum of all aggregate liabilities of the Girard Grocery Company. The insolvency brought about by the million dollar loss in 1920 had not been lifted, and the reduced capital was never replenished. These profits should have been applied to the depleted capital, and so appropriated, there would have then remained no funds out of which to legally pay dividends. With the exception of distributions made in liquidation, dividends can be declared and paid out of net profits only, or, conversely stated, when the payment does not impair the capital stock of the corporation. Nor can an insolvent corporation declare and pay a dividend; and if the capital stock has been impaired by the payment of the dividend, it is nevertheless unlawful, although the corporation is solvent at the time. 14 C.J. p. 800. Hence the absolute and legal duty of respondents, knowing a serious impairment of the capital existed, was to devote the profits here mentioned to the betterment of the company's shattered

financial condition, instead of suppressing their wrongful management of its affairs and lulling suspicion on the part of stockholders by doling the accumulations out in the shape of dividend payments. In this connection we may adopt the conclusions of the learned court below, as follows:

"It is argued by counsel for the respondents that the impairment of the capital occurred prior to the declaration of the dividends in question, and all that the directors did was to fail to reduce an impairment that existed. This argument overlooks the fact, however, that by declaring the dividends each year out of current profits, the directors illegally diverted funds which properly were applicable to a reduction of the capital deficit. The earned profits, therefore, reduced the impairment, and the declaration of the dividend again impaired the capital to the extent of the dividends declared."

In our opinion, we need not enter further into this discussion. It is undisputed that respondents by illegal methods made and continued concealment, from both the stockholders of the company and the public, of the precarious financial standing of the corporation, repeatedly inflating inventories of goods on hand, thus presenting a fraudulent overvaluation of assets, and lastly, declared dividends, at the time the corporation was insolvent and its capital seriously depleted and impaired, out of profits that should have been used for its stabilization. The court below found the disbursements were illegal, under the Act of May 23, 1913 (P.L. 336; Pa.St.1920, § 5786), and that the directors are personally liable for the dividends so declared. We concur in that judgment.

The decree of the court below is affirmed, at appellants' costs.

OTTINGER v. BENNETT.

Supreme Court of New York, Appellate Division, First Department, 1911.
144 App.Div. 525, 129 N.Y.S. 819.

Action by Marx Ottinger and others against John R. Bennett, impleaded, etc. From a judgment sustaining plaintiff's demurrer to a partial defense, defendant appeals. Reversed, and demurrer overruled, with leave to complainant to amend his complaint.

INGRAHAM, P. J. Upon an appeal from a judgment sustaining a demurrer to a separate defense set up in the answer, the defendant attacks the sufficiency of the complaint, and, as I do not think the complaint alleges a cause of action, the judgment should not be affirmed.

The complaint alleges that the American Ice Company, a corporation organized under the laws of the state of New Jersey, had issued preferred and common stock, and on January 23, 1902, the board of directors of said company declared a dividend of $1 per share upon the common stock of the American Ice Company payable to stockholders of record at the close of business on February 1, 1902, which dividend was subsequently paid to the stockholders; that this dividend was not made or declared from the surplus or net profits arising from the business of the said American Ice Company, and the said dividend

was never earned by the said American Ice Company; that at the time of the declaration of this dividend the statutes of the state of New Jersey provided that no corporation should make a dividend except from the surplus or net profits arising from its business, nor divide, withdraw, or in any way pay to the stockholders or any of them any part of its capital stock except according to the act, and, in case of any violation of its provisions, the directors under whose administration the same may happen should be jointly and severally liable, at any time within six years after paying such dividend, to the corporation and to its creditors, in the event of its dissolution or insolvency, to the full amount of the dividend made or capital stock so divided, withdrawn, paid out, or reduced, with interest on the same from the time such liability accrued, provided that any director who may have been absent when the same was done, or who may have dissented from the act or resolution by which the same was done, may exonerate himself from such liability by causing his dissent to be entered at large on the minutes of the directors at the time the same was done, or forthwith after he shall have notice of the same and by causing a copy of such dissent to be published in certain newspapers. The complaint further alleges that the defendant John R. Bennett was a director of the American Ice Company between January 1, 1902, and March 1, 1902, and well knew that at the time the said dividend was declared the same had not been earned and was not declared from the surplus or net profits arising from the business of the said corporation; that the said defendants caused the fact of the declaration of the dividend to be published in the newspapers and to be disseminated among the public; and that none of the directors caused his dissent to be entered at large or otherwise on the minutes of the directors of the American Ice Company. There was no allegation that this defendant Bennett was present at the time the dividend was declared, voted for the dividend, or took any part in the action of the corporation in declaring a dividend.

It is alleged that each of the directors intended that the said declaration of the said dividend should be regarded by the general public as a representation that the said dividend had been earned and declared from the surplus or net profits arising from the business of the said American Ice Company, and it is then alleged that, at the time of the declaration of the said dividend, each of the said directors well knew that the aforesaid representations were wholly false, and that said representations were made with intent on the part of each of said directors to deceive the public and to induce the public to purchase shares of the capital stock of the American Ice Company, and that said directors conspired together for that purpose. It is also alleged: That the plaintiff, relying upon the said representations, and believing them to be true, purchased on February 13, 1902, 100 shares of the common stock of the American Ice Company; on or about March 5th, purchased 200 shares of the common stock of the American Ice Company; on or about April 28, 1902, purchased an additional 100 shares of said common stock; and on August 25, 1902, purchased a further 200 shares of the said common stock, and paid therefor the sum of $12,675. That if the dividend mentioned in paragraph 5 of the com-

plaint had been declared out of the surplus or net profits of the said American Ice Company, each share of the common stock would have been worth $50 per share at the time of the declaration of the said dividend mentioned. The common stock of the American Ice Company was intrinsically worthless and practically of no value. And that the market price of the said common stock subsequently "declined to a point where said market price, as well as said intrinsic value of the said stock, is practically nothing." Thus the basis of the plaintiff's cause of action is that the directors of the American Ice Company, by declaring a dividend on its common stock which was paid by the company, represented that such dividend was to be paid out of its earnings and net profits, and, without alleging that the defendant voted for such dividend or took any part in declaring it or made any representations about it, plaintiff seeks to hold this defendant for his loss in a speculation in the stock, because the defendants knew that the dividend was not paid out of earnings or profits, but intended that it should be understood by the public that it was paid out of earnings and profits.

The corporation being organized under the laws of the state of New Jersey, the legality of the acts of the directors must be determined by the laws of that state. The laws of that state prohibited the declaration of a dividend except from surplus or net profits arising from its business, and provided a penalty for a violation of this prohibition by making the directors under whose administration the same may happen jointly and severally liable to the corporation and to its creditors in the event of its dissolution or insolvency to the full amount of the dividend made or capital stock so divided. It is not alleged that this company has ever become insolvent, and the plaintiff is not a creditor. Nor does the plaintiff seek to compel the directors to pay back to the company the amount of the dividend that they distributed to the stockholders in violation of the statute. He alleges that the declaration of this dividend was a representation that it was paid out of net earnings or profits, but it is not alleged that the dividend was declared to be paid out of profits or earnings; that there was any direct representation by either the company or its directors that it was so paid; nothing but the bare allegation that a dividend was declared and paid by the company —how is not stated—and that therefore the plaintiff is entitled to recover, not the amount of the dividend or the loss that the company sustained in consequence of the dividend having been declared, but what he lost in an unfortunate speculation in the stock because he believed that the dividends had been paid out of earnings or profits.

To sustain this action there must first be a representation by the person sought to be charged of a fact which was false and upon which the plaintiff relied. If no representation was made, there can certainly be no action based upon the falsity of a representation.

The statute prohibiting the declaration of such a dividend provided the penalty that should follow, but that was only a liability to the corporation itself or to a creditor, and then only in the event of the dissolution or insolvency of the corporation. Nothing else could happen to these directors because of their disobedience to this statute except such a liability to the corporation or its directors.

In speaking of a domestic corporation which had declared a dividend in violation of the statutes of this state, the Court of Appeals, in People ex rel. E. G. E. Co. v. Barker, 141 N. Y. 254, 36 N.E. 196, said:

"That penalty, and the only one imposed, is that the trustees shall become liable for all debts existing and contracted during their term of office, * * * and the practical effect follows that for the security of creditors the liability of the trustees is put in the place of the impairment of capital effected by the dividends. If the trustees choose to bear that responsibility, they have power to declare and pay the dividend, though no surplus exists beyond the capital, at least until some judicial restraint intervenes to prevent."

If the directors thus had power to declare a dividend out of capital subject only to the penalty provided by the New Jersey statute for a violation of its prohibition, it certainly could be no representation that the dividend was declared payable out of anything but capital by the mere declaration of the dividend. It is not alleged that this defendant or any of the directors had any stock to sell or declared this dividend for the purpose of creating a market for their stock; that they sold any stock based upon the declaration of this dividend; or that the plaintiff purchased any stock belonging to the defendants or any of them. The plaintiff saw that the dividend was declared, he assumed that it was payable out of profits, and he went into the general market and bought the stock. What he assumed to be the fact was not the fact.

If, by the declaration of this dividend, there was no representation as to whether it was paid-out earnings or capital, then it seems to me the intention of the defendants was entirely immaterial.

This defendant owed no duty to the plaintiff; he was not in a position whereby he was bound to inform the plaintiff or any one else that this dividend was not paid out of earnings but was paid out of capital; no duty devolved upon him to speak; and his mere silence in the face of the declaration of a dividend paid out of capital and not of earnings was not, as I look at it, a declaration or representation of any fact except that a dividend would be paid by the corporation at the time and place named. Certainly as to a defendant who had taken no part in the declaration of the dividend—and it is not alleged that this defendant did take such a part—there can be no representation upon which to base a recovery.

The plaintiff relies upon Keeler v. Seaman, 47 Misc.Rep. 292, 95 N.Y.Supp. 920, decided by Mr. Justice Scott, now a member of this court, at Special Term. That action was against an officer of the company, not a director. In that case the directors had declared a dividend which was payable out of the earnings, not, as in this case, a dividend which was merely payable out of the money of the company. But it is quite clear that the mere declaration of that dividend would not have charged the defendant, who was not a director, and the allegations of the complaint which made him liable were that he was instrumental in causing notice of the declaration of the dividend to be advertised, and that he knew that certain statements contained in the advertisement were false. It was also alleged that this defendant au-

thorized a firm of stock brokers to state to intending purchasers of the said stock that the net earnings of the corporation amounted to more than 1 per cent. a month upon its capital stock, and that such statement was false to the knowledge of the defendant and was made with intent to deceive intending purchasers. There were also other allegations in the complaint charging, in effect, that the demurring defendant actively co-operated with the defendants and directors of the corporation to perpetrate a fraud upon possible purchasers of the company's stock by circulating, and causing to be circulated, false and misleading statements as to the financial condition of the corporation, and the decision was based upon these false representations and his belief in the truth thereof that the complaint was sustained. There were direct representations by the demurring defendant made to stock brokers for the purpose of influencing the public to purchase stock of this corporation, and the decision was not at all based upon the fact of the mere declaration of the dividend by the corporation. It also appeared in that case that the dividend was declared to have been paid out of earnings, when in fact it was paid out of capital. These facts show that that case presents features which established that the demurring defendant had made a direct representation that the dividend was payable out of earnings, and not out of capital, and that seems to me to be the controlling difference between that case and the one now under consideration. Here there was a simple declaration of a dividend without stating out of what funds it was to be payable, except that it was payable by the corporation, and it seems to me that such a declaration of a dividend is not a declaration of any fact upon which can be predicated a claim of a false and fraudulent representation as to the method by which the corporation had acquired the money to pay the dividend, and certainly not against a director who had taken no part in declaring the dividend. As the complaint does not state a cause of action, it is not necessary to determine whether the defense demurred to is sufficient.

I think, therefore, this judgment should be reversed, with costs, and the demurrer overruled, with costs, with leave, however, to plaintiff to amend his complaint upon payment of costs in this court and in the court below.

MCLAUGHLIN and SCOTT, JJ., concur.

MILLER, J. (dissenting). The appellant challenges the sufficiency of the complaint. The action is for fraud and deceit in inducing the plaintiff to purchase shares of the capital stock of the American Ice Company. The defendants were directors of said company. It is alleged that the directors declared a dividend on the common stock and caused it to be paid out of capital, there being no surplus or earnings, in violation of the statute of New Jersey, in which state said company was incorporated; that they caused the fact of the declaration of said dividend to be published in the newspapers and disseminated among the public; that well knowing the falsity thereof, and intending thereby to deceive the public and to induce them to purchase the shares of stock of said company, each of said defendants intended said declara-

tion of dividend to be regarded as a representation that it had been earned and was declared from surplus and net profits; that in reliance thereon, and in the belief that said representation was true, the plaintiff purchased 600 shares of the said stock and was thereby damaged in a sum stated.

The plaintiff pleaded the New Jersey statute; but the action is not brought thereon. It may be assumed that the remedy given by the statute is exclusive; but an action for fraud and deceit can hardly be said to be statutory. The fact that it was unlawful to declare dividends except from surplus or the net profits arising from the conduct of the business is an element to be considered, in determining the quality of the defendants' act as a representation, and the reliance which the public might naturally be expected to place upon it as such.

It is familiar law that a fraudulent representation may be effected by conduct, by acts as well as by words, by silence when there is a duty to speak, by half-truths calculated to mislead, or by reckless statements made without knowledge. * * * It is equally well settled that the representation need not be made directly to the party injured by it (Brackett v. Griswold, 112 N.Y. 454, 20 N.E. 376), and that one who is induced to enter into a contract by the false representations of a third party may have a right of action against the latter for the wrong (Kujek v. Goldman, 150 N.Y. 176, 44 N.E. 773, 34 L.R.A. 156, 55 Am.St.Rep. 670). The principle of the decisions is that a party is answerable for what he intends to accomplish; that one who intentionally deceives another to his injury, no matter how, is accountable for the wrong; that a party is liable for misrepresentations, either by conduct or by words, made for another to act upon, if they were calculated to deceive, and if in fact they do deceive such other person into acting in reliance upon them to his injury. It is quite as easy to deceive by acts as by words, and the deed is often more effectual than the word. But the law is not so blind or so absurd as to judge an act by the means regardless of the motive.

Tested by the application of those principles, the complaint in the case at bar alleges all the essentials of an action for fraud and deceit, i. e., a representation by acts for the public, and therefore for the plaintiff, to act upon—falsity, scienter, deception, and injury. A declaration of a dividend by a going concern implies earnings from which to pay it, and the publication of the fact of such declaration is certainly calculated to induce the public to believe that the dividend has been earned and that the corporation is prosperous. If, intending the public to act thereon, the defendants had made and published a report expressly stating that the dividend declared had been earned, there would be no doubt of their liability to a person thereby deceived to his injury. The familiar cases of false prospectuses need not be cited. Why distinguish between a false affirmation and an act calculated to have the like effect; the motive and the result in each case being the same? Certainly the law makes no such distinction. We have had many illustrations in cases before us of the devices to deceive the public employed by managing directors, who misuse their positions to

promote stock speculation, and the payment of dividends out of capital is a familiar one. When that is done to induce the public to purchase shares of the company and thereby to create a fictitious value, upon which the wrongdoers may trade, they should be held accountable precisely as though the like deception had been practiced by actual misstatements.

The novelty of the action need not deter us from applying settled principles of law; but the case is not entirely without precedent. Keeler v. Seaman, 47 Misc. 292, 95 N.Y.S. 920; Stainback v. Fernley, 8 L.J. Ch. 142, 3 Jur. 262. The latter case was decided in 1839. It should be said that those cases involved misstatements; but it was considered in each that the very act of declaring a dividend was a representation to the public that it had been earned. Perhaps Bedford v. Bagshaw, 29 L.J. (N.S.) Com.Law, 59, is more nearly analogous to this case. In that case directors procured the shares of their company to be inserted in the official list of the Stock Exchange, by a misrepresentation that two-thirds of the scrip had been paid upon; and it was held that the directors were liable to third persons who were induced to purchase shares in reliance upon the fact that they were listed.

It is not expressly alleged, though it may fairly be inferred from the facts stated, that the appellant was present at the meeting of directors when the dividend was declared. Moreover, his actual participation in the fraudulent scheme to deceive the public is alleged.

Of course, there was no representation to the plaintiff as to the condition of the company, unless the dividend was declared and the fact of its declaration published for the purpose of inducing the public to purchase the shares of the company in the belief that the dividend had been earned. The act itself, though in violation of the statute, would not give third parties a cause of action for fraud and deceit, unless done for them to act upon. To establish that the act was a representation to the plaintiff, he will have to prove the act and the fraudulent purpose as independent elements. It would be premature now to decide what proof would suffice to establish the latter element. It is sufficient for the present appeal that the complaint contains the necessary averments.

As a partial defense, the appellant alleged that a plan was devised by certain of the stockholders of the American Ice Company to reduce the losses incurred by the holders of stock through the decline in its market price, which was the organization of a holding company and the exchange of its stock for the common stock of the American Ice Company in the ratio of one to five; that the plaintiffs could have effected such an exchange and sold the stock received in exchange for a sum stated, and thereby could have reduced their loss. Of course, the stockholders did not have to take stock in a new company, and the matter pleaded is not a defense, partial or otherwise, to the plaintiff's cause of action. It may have a legitimate bearing on the value of the stock, which they were induced to purchase. If so, it can be proved,

without being pleaded, as a fact relevant to the question of damages.

The interlocutory judgment should be affirmed, with costs.

DOWLING, J., concurs.[20]

AIKEN et al. v. INSULL et al.

Circuit Court of Appeals of the United States, Seventh Circuit, 1941.
122 F.2d 746.

Action by Thomas D. Aiken and others, on their own behalf as owners and holders of corporate debentures and on behalf of all other owners and holders of such debentures and all other creditors who desired to join in the suit and share the costs thereof, against Samuel Insull, Jr., and others, for an accounting and for other relief. From judgment for the defendants, the plaintiffs appeal.

Judgment affirmed in part and in part reversed and case remanded, with directions to proceed in accordance with opinion.

KERNER, CIRCUIT JUDGE. In this case plaintiffs, on their own behalf as owners and holders of corporate debentures and on behalf of all other owners and holders of such debentures and all other creditors who desired to join in the suit and share the costs thereof, sought an accounting from the defendants, directors of the Insull Utility Investments, Inc., for the wrongful pledging of assets in violation of certain debenture covenants and for the improper declaration of dividends. The defendants interposed an affirmative defense and moved for summary judgment against the plaintiffs, filed under Rule 56 of the Federal Rules of Civil Procedure, 28 U.S.C.A. following section 723c. The District Court sustained the motion, dismissed the complaint and entered a decree in favor of the defendants. From that decree this appeal is prosecuted.[21]

The complaint filed on February 3, 1933 alleged that I.U.I. was incorporated under the laws of Illinois to acquire, dispose of, underwrite and deal in securities and to do a general investment business; the election of the defendants as directors; the composition of the Executive & Finance Committees; the issuance of certain debentures aggregating approximately $66,000,000 and the sale thereof. The debentures were long term, interest bearing obligations of $1,000 each, unsecured except for restrictive covenants on the power of I.U.I. to borrow and pledge.

The complaint further alleged that the defendant directors of the I.U.I. induced and caused I.U.I. to borrow about $45,000,000 from certain Chicago and New York banks, and induced and caused I.U.I. to pledge with said banks substantially all its assets as collateral to said loans without securing the outstanding debentures equally and ratably with such loans and without securing them whatsoever, and that neither all nor any of said loans was made for a period not exceeding one year.

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[20] Order reversed and interlocutory judgment affirmed on dissenting opinion of Miller, J., below, Ottinger v. Bennett, 203 N.Y. 554, 96 N.E. 1123 (1911).

[21] In this opinion Insull Utility Investments, Inc., will be designated as I.U.I.

The complaint also alleged that on April 16, 1932 an involuntary petition in bankruptcy was filed against the I.U.I., that it was on September 22, 1932 adjudicated a bankrupt, and on March 7, 1937 Harry A. Bigelow was appointed trustee of I.U.I. * * *

The complaint also charged the defendants with the violation of § 23 of the Corporation Act (1919).[22] It alleged that on December 13, 1931 the liabilities of I.U.I. exceeded the fair market value of its assets and that I.U.I. was insolvent; that during 1929, 1930, 1931 and 1932 it had no surplus, but nevertheless paid cash dividends during each of these years on all classes of its preferred stock; that certain of the defendants served as members of the Executive Committee, and that all of the defendants constituted the Board of Directors continuously during the period in question; that the Executive Committee first authorized and directed the payment of the cash dividends above mentioned and that the Board of Directors then authorized or ratified this action. For instance, on January 9, 1932, at a meeting of the Board of Directors, at which all of the directors were present except two specifically named, a resolution was unanimously adopted approving the action of the Executive Committee in declaring a cash dividend payable as of January 2, 1932. The District Court, in his memoranda of holdings, indicated that he did not consider the allegations concerning the improper payment of dividends sufficient in detail. Thereupon the plaintiffs asked leave to file amendments to the complaint, but leave to amend was denied because of the lapse of time between the filing of the original complaint and the offering of the amendment.

The proposed amendments show in complete detail the part played by each defendant with respect to the authorization, declaration, approval, or ratification of each dividend. They show the details of the dividends declared, the dates of the directors' meetings at which they were declared, the names of the directors present at each meeting and the voting therefor, the amount of the dividends so declared, and that at all of the times at which the dividends were paid, I.U.I. was wholly and irretrievably insolvent and that the dividends impaired the capital of the company.

In considering the question presently discussed, it is not, we believe, unreasonable to suppose that directors of a corporation ought to know whether the actual earnings authorize the withdrawal of the corporate assets to pay a dividend, since they alone are responsible for the declaration of dividends even though they may have delegated the power to a committee of their own.

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22 Laws of Illinois, 1919, p. 321: "The directors shall jointly and severally be liable for the debts and contracts of the corporation in the following cases:

"(1) * * *;

"(2) For declaring or assenting to a dividend if the corporation is, or is thereby, rendered insolvent, or its capital is thereby impaired, to the extent of such dividend;

"(3) * * *.

"Unless a director was absent from the meeting at which such dividend was declared or loan made, or unless his dissent therefrom shall be entered on the corporate records, he shall be conclusively presumed to have assented thereto." Smith-Hurd Stats.Ill. c. 32, § 157.42 note.

The statutory liability is conditioned upon the presence of two essential elements, namely, (1) the "declaring or assenting to a dividend" on the part of the corporate directors, accompanied by (2) the insolvency of the corporation or the impairment of its capital. This liability exists only if the directors voluntarily and affirmatively participate or co-operate in the wrongful payment of dividends. See Lewis v. Montgomery, 145 Ill. 30, 33 N.E. 880; Slater v. Taylor, 241 Ill. 102, 89 N.E. 271; McCutcheon-Gerson Service v. Tire & R. Co., 236 Ill.App. 261. Manifestly, this would occur if the directors played a voluntary part in the declaration or creation of the dividend, or if they approved of or assented to its creation. * * *

It is true that the liability under § 23 of the Corporation Act of 1919 is personal to the creditors, and a suit to enforce the liability must be brought by one or more creditors on behalf of all creditors. Ryerson & Son v. Peden, 303 Ill. 171, 184, 135 N.E. 423, 24 A.L.R. 1273, Seegmiller v. Day, 7 Cir., 249 F. 177, 179. See also Low v. Buchanan, 94 Ill. 76, and Woolverton v. Taylor, 132 Ill. 197, 23 N.E. 1007, 22 Am. St.Rep. 521. This suit was brought on behalf of all creditors.

It is argued that the statutory liability is penal in character and hence a suit can not be maintained in equity to enforce such liability. Loverin v. McLaughlin, 161 Ill. 417, 435, 44 N.E. 99, is the authority relied upon by the defendants. The liability imposed by the statute is definitely not penal in character. It is, both in form and substance, a private obligation, similar, in many respects, to that of sureties, and it was intended to afford additional security to the creditors. See Low, Taylor and Lewis cases, supra; Vestal Co. v. Robertson, 277 Ill. 425, 431, 115 N.E. 629 and In re Beachy & Co., D.C., 170 F. 825, 828. * * * The debentures in question contained a clause which provided that "No recourse shall be had for the payment of the whole or any part of the principal or interest of this debenture to or against the * * * directors of the Company * * *." The District Court concluded that the "no recourse" clause did not operate as a bar to this action. In addition, plaintiffs negotiated a settlement with four of the defendants, and concededly this settlement assumed the form of a covenant not to sue. The District Court held that the effect of the settlement was a covenant not to sue, and therefore was not a bar to this action. In our opinion the conclusions of the District Court on these two points were correct.

The judgment relating to the wrongful pledges is affirmed. The judgment relating to the wrongful payment of dividends is reversed. The case is remanded with directions to proceed in accordance with this opinion.[23]

DE MET'S INCORPORATED v. INSULL.

Circuit Court of Appeals of the United States, Seventh Circuit, 1941.
122 F.2d 755.

Appeal from the District Court of the United States for the Northern District of Illinois, Eastern Division; Charles G. Briggle, Judge.

Representative action by De Met's Incorporated against Samuel

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23 Cert. den., 315 U.S. 806, 62 S.Ct. 638, 1942.

Insull and others for improper pledging of corporate assets and for improper payment of dividends in violation of Illinois law. From an adverse judgment, plaintiff appeals.

Judgement affirmed in part and in part reversed and case remanded, with directions to proceed in accordance with opinion.

KERNER, CIRCUIT JUDGE. This is a representative suit brought by De Met's Incorporated, a holder of corporate notes, against the directors of the Corporation Securities Co. of Chicago, a bankrupt corporation, for the improper pledging of the corporate assets, and for the improper payment of dividends in violation of § 23 of the Illinois Corporation Act of 1919, Laws of Illinois, 1919, p. 321, Smith-Hurd Stats.Ill. c. 32, § 157.42 note. * * *

In this case defendant Field contends he stands on a basis distinct from the other defendants in that his participation in the affairs of the Securities Co. was considered by the Superior Court of Cook County, Illinois, in an action brought by Howard, Trustee in Bankruptcy of Corporation Securities Co.; that all charges directed against him in that case were identical to those here made and that they were adjudicated in his favor. Howard v. Insull, 294 Ill.App. 20, 13 N.E.2d 506. As before noted, the Howard case was brought by Howard as trustee. It involved the charge that the assets of the Securities Co. were unlawfully expended and that dividends had been improperly and illegally declared. In the Howard case Field contended that if there be a cause of action as to dividends, it belonged to the creditors, not to Howard as trustee, in bankruptcy. The nisi prius court sustained the contention and dismissed the complaint. The appellate court affirmed. * * * The statutory cause of action against the directors for improper dividends is personal to the creditors and that suit to enforce the liability lies in one or more of the creditors acting in representative capacity. Seegmiller v. Day, 7 Cir., 249 F. 177 holds that although the statutory cause of action is personal to the creditors, the trustee may nevertheless maintain a suit against the defendant directors of an insolvent corporation to recover unearned dividends illegally paid to the defendants themselves as stockholders. The court in the Howard opinion concluded that its result was consistent with the Ryerson and Seegmiller decisions. We assume that the Court's conclusion is sound, otherwise there would be no choice but to add that the Howard result is not the law. * * * In the instant case the board of directors empowered an executive committee to declare dividends, which of course did not operate to relieve them of the responsibility. We believe that a corporate director participates in a dividend, that is, declares or assents to a dividend, under the statute, if he votes to give such an executive committee the power to declare a dividend and this is done, if he himself is an active member of the executive committee which declares a dividend, or if he approves, ratifies or assents to a declaration of the executive committee. We think that the pleadings in this case, as in No. 7430, sufficiently charge the defendants with participation. Perhaps the evidence will not show this. Perhaps the evidence will show, as to

one or more of the defendants, a want of control or command, an attitude of gross negligence, an irregular attendance plus perfunctory exercise of the voting power, see Lewis v. Montgomery, 145 Ill. 30, 48, 33 N.E. 880, and Slater v. Taylor, 241 Ill. 102, 89 N.E. 271. Perhaps the evidence will not show this, but that is not important now.

The judgment as to the cause of action relating to the pledges, is affirmed. The judgment as to the cause of action relating to the dividends, is reversed. That portion of the opinion rendered in case No. 7430 which is applicable here, is incorporated by reference. The case is remanded with directions to proceed in accordance with this opinion.

It is so ordered.[24]

WOOD v. NATIONAL CITY BANK.

Circuit Court of Appeals of the United States, Second Circuit, 1928. 24 F.2d 661.

Suit by Howard O. Wood, as ancillary receiver of the Stanton Oil Company, against the National City Bank and others. Decree dismissing the bill on motion, for insufficiency on its face, and plaintiff appeals. Affirmed, without prejudice to grant an amendment.

The amended bill set forth the following facts: At some undisclosed time the District Court for the Eastern District of Kentucky appointed a receiver for the Stanton Oil Company a Delaware corporation, and later the plaintiff was appointed ancillary receiver "by an order entered in the District Court of the United States for the Southern District of New York." The nature of neither suit was disclosed. From July 16, 1917, to April 1, 1919, the defendants were stockholders of the corporation, between which dates they had received certain dividends from its assets. At the time when all these dividends were paid, the corporation "was in debt, and was in fact insolvent and unable to pay its debts, and had not then, nor had it ever had, any reserve over and above its capital stock, or any surplus or net profits of any kind, and each and all of the said dividends were paid wholly from and out of the capital of said corporation." Claims had been "filed" against the corporation, amounting to more than $100,000, and receiver's certificates issued in the sum of $25,000.

L. HAND, CIRCUIT JUDGE (after stating the facts as above). It is impossible from the bill to learn just what the plaintiff meant to allege. On the one hand, he may have meant only that, when the dividends were paid, the corporate assets did not equal its debts together with the aggregate amount of its corporate shares, considered as a liability, and that the payments left the assets insufficient to pay the shares in full. On the other hand, he may have meant that the assets were not at those times enough to pay the debts; that is, that the corporation was insolvent, as that word is used in the Bankruptcy Act (11 U.S.C.A.). Considering the liberal attitude which courts now take towards pleadings, we think that some of the language is susceptible of being understood in the second sense. "Unable to pay its debts"

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[24] Cert. den., 315 U.S. 806, 62 S.Ct. 638, 1942.

certainly says more than that the corporation has failed to pay them in due course. It more naturally means that the assets were not enough for that purpose. We must, it is true, confess to a complete inability to understand the relevancy of the remainder of the third article of the bill, in which these words appear. They strongly suggest that the gist of the suit was the receipt of dividends paid in depletion of capital, without regard to whether the corporation was solvent or insolvent. However that may be, if there is a sufficient allegation of insolvency, as we think, the bill is at worst only indefinite and ambiguous, and the proper remedy was to move under rule 20 for a better statement, not to dismiss it under rule 29.

Such being a permissible construction of the complaint, the question of its sufficiency depends upon the law of stockholders' liability. We have not to do with the liability commonly imposed by statute, because, whatever that may be in Delaware, the plaintiff does not invoke it here. He depends upon the fact that the directors have paid, and the defendants received, dividends when the corporation was insolvent. Merely because this impairs the capital stock, it is commonly regarded as a wrong to creditors on the directors' part, and it is often made such by statute. We may, without discussion, assume that it would be a wrong in the case at bar. Even so, it is primarily only the wrong of those who commit it, like any other tort, and innocent participants are not accomplices to its commission. Hence it has been settled, at least for us, that, when the liability is based merely on the depletion of the capital, a stockholder must be charged with notice of that fact. McDonald v. Williams, 174 U.S. 397, 19 S.Ct. 743, 43 L.Ed. 1022. This has become a thoroughly fixed principle in the federal courts. Lawrence v. Greenup (C.C.A.6) 97 F. 906; New Hampshire Savings Bank v. Richey (C.C.A.8) 121 F. 956; Great Western, etc., Co. v. Harris (C.C.A.2) 128 F. 321; Ratcliff v. Clendenin (C.C.A.8) 232 F. 61; Atherton v. Beaman (C.C.A.1) 264 F. 878.

It is apparent that this result could not have been reached if the capital of the corporation were regarded as a trust fund for its creditors, because a stockholder is not a purchaser, but a donee, and his bona fides would not protect him, in the absence of some further equity, in retaining the proceeds of a trust. So it became necessary to decide that the capital was not such a fund, and McDonald v. Williams did expressly so decide. The so-called "trust fund" doctrine had, indeed, earlier been repudiated by the Supreme Court, especially in Hollins v. Brierfield, etc., Co., 150 U.S. 371, 14 S.Ct. 127, 37 L.Ed. 1113; but it was a hardy weed and would not die at the first uprooting. It is apparent, therefore, that the bill does not set forth a cause of suit based upon the impairment of the capital, because the stockholders are not alleged to have been privy to the directors' tort. This is not a defense which must be pleaded, like that of bona fide purchaser; it is necessary positively to allege the stockholders' complicity in the wrong to set forth any case at all.

However, there is quite another theory, and quite another liability, if the payments not only impair the capital, but are taken out of assets

already too small to pay the existing debts. The situation then strictly is not peculiar to corporation law, but merely an instance of a payment from an insolvent estate. Since, as we have said, a stockholder is a donee, he receives such payments charged with whatever trust they were subject to in the hands of the corporation. In that situation it can indeed be said with some truth that the corporate assets have become a "trust fund." Wabash, etc., Ry. v. Ham, 114 U.S. 587, 594, 5 S.Ct. 1081, 29 L.Ed. 235. Hence it has never been doubted, so far as we can find, at least in any federal court, that if the dividends are paid in fraud of creditors the stockholder is so liable. Hayden v. Thompson (C.C.A.8) 71 F. 60; Hayden v. Williams (C.C.A.2) 96 F. 279. The defendants, who suppose that there has been an inconsistency in the decisions of the Eighth Circuit (and they might have added in our own), have failed to distinguish the quite independent bases of the two liabilities.

If the bill be regarded as presenting only an instance of a payment in fraud of creditors, the question arises whether it is enough merely to allege that the payment was made while the corporation was insolvent. It is agreed with substantial unanimity that, when an insolvent makes a voluntary payment out of his assets, it is regarded as at least presumptively in fraud of his creditors. [Citing cases.] * * *

We shall assume, for argument, in accordance with the language of some of the foregoing decisions, that such a transfer is fraudulent per se. In Hayden v. Williams no more is mentioned than that the corporation was insolvent, and apparently no more was thought necessary. Even so, the bill is bad, because, when the invalidity of the gift depends only upon the fact of the donor's insolvency, regardless of his intent, it is voidable only at the demand of creditors existing when it is made. [Citing cases.] * * *

In the case at bar the bill does not allege that any of the creditors in existence when the receiver was appointed were creditors when the dividends were declared. Only in case the bill had alleged this, would the question arise whether insolvency per se avoids the gift. For this reason, and this alone, the decree was right.

Our mandate will contain a provision that the affirmance is without prejudice to the power of the District Court to grant a second amendment. * * *

The plaintiff will then have an opportunity to allege, if he deems it necessary, that the dividends were paid in fraud of creditors, and that some of the creditors existing when the receiver was appointed existed also when the dividends were paid. * * *

Decree affirmed.

NOTE

(A) Where dividends are paid from capital to stockholders who receive them in good faith, neither a receiver nor a trustee in bankruptcy may recover the dividend or its value. McDonald v. Williams, 174 U.S. 397, 19 S.Ct. 743, 43 L.Ed. 1022, 1899, 1915, 15 Col.L.Rev. 547; Bates v. Brooks, 222 Iowa 1128, 270 N.W. 867, 109 A.L.R. 1371, 1937; but cf., 1930, 28 Mich.L.Rev. 337. But, if dividends are paid when the corporation is insolvent, the stockholders may be held liable on the theory that the corporate assets at that time have become a trust fund for creditors. Hayden v. Williams, 96 F. 279, C.C.A.N.Y.1899, 1911, 11 Col.L.Rev. 477; Wood v.

National City Bank, 24 F.2d 661, C.C.A.N.Y.1928, 1929, 38 Yale L.J. 542; Bartlett v. Smith, 162 Md. 478, 161 A. 509, 1932, Note, 1933, 18 Iowa L.Rev. 516, 1932, 16 Minn.L.Rev. 706. See, also, Briggs, Stockholders' Liability for Unlawful Dividends, 1933, 8 Temp.L.Q. 145; Jennings, The Minnesota Business Corporation Act, 1937, 12 Wis.L.Rev. 419, 450; Notes, 1928, 55 A.L.R. 8, 73–133; 1932, 76 A.L.R. 885, 892–895; 1939, 109 A.L.R. 1381, 1388–1400; Recovery of Illegal Dividends from Stockholders, 1932, 2 Brooklyn L.Rev. 82; 1933, 33 Col.L.Rev. 481; 1932, 30 Mich. L.Rev. 1070; Shareholders' Responsibility for Improper Dividends, 1938, 81 U. of Pa.L.Rev. 314; 1933, 3 Brooklyn L.Rev. 141; 1930, 28 Mich.L.Rev. 337.

(B) In an action against corporate directors to recover dividends alleged to have been illegally declared, the court will not upset the directors' valuation of the corporate assets in the absence of a showing of bad faith. Where directors declare a dividend, there is a presumption that this is done in good faith and that net profits are available from which to meet the dividend payments. Gallagher v. New York Dock Co. et al., 19 N.Y.S.2d 789, Sup.1940, aff'd 263 App.Div. 878, 32 N.Y. S.2d 348, 1942.

UNITED LIGHT & POWER COMPANY v. GRAND RAPIDS TRUST COMPANY.
GRAND RAPIDS TRUST COMPANY v. UNITED LIGHT & POWER COMPANY.

Circuit Court of Appeals of the United States, Sixth Circuit, 1936. 85 F.2d 331.

Suit by the Grand Rapids Trust Company, receiver of the Grand Rapids, Grand Haven & Muskegon Railway Company, against the United Light & Power Company. From the decree (7 F.Supp. 511), the defendant appeals, and the receiver cross-appeals.

Affirmed as modified.

HICKS, CIRCUIT JUDGE. This suit is ancillary to one brought by the Guaranty Trust Company of New York, trustee, to foreclose a mortgage executed by Grand Rapids, Grand Haven & Muskegon Railway Company (hereinafter called the railway). * * * The receiver sued to recover a total of $579,000 paid to appellant and its predecessor in stock dividends, * * *

The District Judge allowed a recovery of dividends paid after December, 1922, at which time he ruled the railway to have become insolvent; * * *

Cross-appellant, the receiver, contends principally: That dividends from 1912 to 1921, inclusive, were not paid out of surplus or profits but out of capital, and that such payments were in impairment of capital and hence unlawful; that the payments of dividends under such circumstances was an evidence of bad faith on the part of the stockholder (United) in receiving them; that the court erred in not holding that reserves should have been set up to offset depreciation in the property; * * *

It is urged that the bill of complaint is insufficient, in that the receiver sued as the representative of creditors without alleging that any of the payments complained of were made after insolvency. It is perhaps enough to say that there was no motion to dismiss the bill for insufficiency as provided by Equity Rule 29, 28 U.S.C.A. following section 723; but, aside from this, we think its allegations carry a fair inference of insolvency. * * *

Giving due regard to the findings of the court, we find no reason to disagree with its conclusion that the railway was insolvent in Decem-

ber, 1922. Its assets were then substantially less than its bonds, notes, and current indebtedness. However skillfully and economically it might have been operated, its hope of success had faded with its loss of patronage. It could not reasonably expect to meet its obligations out of earnings. It might have anticipated some such denouement as that of April, 1925. There was no error therefore in adjudging that the dividends of $72,000 on December 22, 1922, and $30,000 on December 10, 1923, were unlawful. Upon those dates these dividends represented a trust fund for the benefit of creditors.

Appellant urges that these dividends were never really paid, but were included in a note for $417,700 executed by the railway to United on November 1, 1924, which remains unpaid. We cannot accede to this view. The United Companies, both appellant and its predecessor, handled the railway's financial affairs. They collected and disbursed the interest on its bonds and borrowed money which they reloaned to the railway and for which they took the railway's notes in return. They ofttimes loaned money to the railway with which to pay dividends. This usage enabled them to show the receipt of regular dividends on their books, the better to maintain their own credit, which, judging from correspondence, was in a more or less strained condition. As it was able, the railway would pay off these notes, but "dividend" notes and others accumulated faster than they were paid, until finally, on November 1, 1924, appellant canceled them all and the railway substituted a single note for $417,700. The District Court held, and we think rightly, that these transactions embodied and were intended to embody actual obligations of the railway. Appellant collected interest on the notes. The total dividends were $579,000, and the high total of promissory indebtedness never exceeded $417,700. A large portion of the dividends was paid in cash, and we think it was expected the remainder would be. Moreover, appellant sold the note for $417,700 in 1925 to the United Motors Products Company, the present holder, to which the railway has since made payments both of interest and principal.

Cross-appellant urges that the railway was insolvent from its organization, that its assets, the railway property, never at any time exceeded its debts and the par value of its capital stock, and that therefore all the dividends were unlawfully declared. But, as indicated above, the stock issue of $1,200,000 was not paid for. It in no sense represented actual capital. We do not understand that under such circumstances the railway was required to maintain assets at a level with its debts and the par value of its outstanding stock. The law was complied with if the assets equaled its debts and the amount for which it was actually liable to its stockholder, that is, the amount received from the stockholder, and any surplus was available in the sound judgment of the directors of the railway for dividends. [Citing cases.] * * *

We have been cited to no case and can find none where the failure of a corporation to keep assets in reserve sufficient to offset the par value of its stock is an impairment of capital to the extent of insolvency where the stock itself has not been paid for. Reduced to its simplest terms, this would mean that a corporation could impair ac-

tual working capital which never existed. This is paradoxical. We apprehend that in cases seeming to hold to the contrary the courts have assumed "par value stock" to mean fully paid up stock. Situations frequently arise where the receiver of an insolvent corporation may require delinquent stockholders to satisfy their unpaid subscriptions for the benefit of creditors, but we have no such case.

To sustain appellant's contention would permit the receiver, representing bondholders, to accomplish indirectly that which it could not accomplish by plenary suit against the stockholder because the original bondholder and stockholder, Westinghouse, Church, Kerr & Co., was identical and it of course knew that the bonds were not issued upon the faith of fully paid-up stock, and that it could not rely thereon for the payment of its debts. See Coit v. Gold Amalgamating Co., 119 U.S. 343, 347, 7 S.Ct. 231, 30 L.Ed. 420; Rickerson Roller-Mill Co. v. Farrell Fdry. & Mach. Co., 75 F. 554, 559 (C.C.A.6). The receiver does not contend that the present bondholders were advised otherwise.

Appellee through its accounting experts strenuously strove to show that the railway paid dividends out of funds that should have properly gone into reserve for depreciation. In this endeavor it offered voluminous testimony designed to show the cost of the railway and a hypothetical life in years for the various items of property and equipment upon which it calculated a yearly depreciation adjustment which would care for them as worn out. These involved calculations showed in 1923 an accumulated deficit of $167,961.53 exclusive of the dividends which had been paid by that time.

We do not feel required to determine whether such reserves were required for the protection of bondholders, for we are not impressed that the property and equipment were irretrievably depreciated in 1922. The Froehlich report was based on exhaustive examination of all the property of the railway, and its estimates indicated that even then it was in 77 per cent. condition. We are not disposed to say that the property was in first-class condition; it was far from it, but we do not feel that it had depreciated so hopelessly that it could not have been pulled up out of operating income had traffic been maintained. We are in accord with the report of the Interstate Commerce Commission of November 2, 1926, No. 15100, "Depreciation Charges of Steam Railroad Companies," that it would have been better practice to maintain depreciation reserves. However, the report recognized that it had been customary with many railroads to maintain operating conditions by charging replacements and repairs to operating expenses, and we think that the bulky evidence of repairs and replacements shows the railway had pursued that course to a marked degree. * * *

The decree of the District Court is in all things affirmed.[25]

NOTE

See generally New York Stock Corporation Law, § 114, Liability of Directors of Foreign Corporations.

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[25] Cert. den., 299 U.S. 534, 591, 57 S.Ct. 118, 119, 1936.

5. TO WHOM DIVIDENDS ARE PAYABLE

NEW YORK STOCK CORPORATION LAW

§ 62. *Determination of stockholders of record for certain purposes.* The board of directors of a stock corporation, unless otherwise provided in the certificate of incorporation or other certificate filed pursuant to law or in the by-laws, may fix a time, not exceeding forty days preceding the date fixed for the payment of any dividend or the making of any distribution, or for the delivery of evidences of rights or evidences of interests arising out of any change, conversion or exchange of capital stock, as a record time for the determination of the stockholders entitled to receive any such dividend, distribution, rights or interests, and in such case only stockholders of record at the time so fixed shall be entitled to receive such dividend, distribution, rights or interests. The board of directors at its option, in lieu of so fixing a record time, may prescribe a period not exceeding forty days prior to the date for such payment, distribution or delivery during which no transfer of stock on the books of the corporation may be made.

IN RE WUICHET'S ESTATE

Supreme Court of Ohio, 1941. 138 Ohio St. 97, 33 N.E.2d 15.

Proceeding in the matter of the estate of Charles Wuichet, deceased. Walter G. Wuichet, trustee under the last will and testament of Charles Wuichet, deceased, filed an application for an order of distribution covering dividends from stock in the Little Miami Railroad Company. On hearing the Probate Court, 3 Ohio Supp. 217, found and adjudged that the dividends in dispute should be distributed by the trustee, to Mary W. Blum. On appeal judgment was affirmed by the Court of Appeals, and the Supreme Court allowed a motion to certify.—[Editorial Statement.]

Judgment affirmed.

The agreed statement of facts then recites four resolutions passed by the board of directors of the Little Miami Railroad Company, all on January 31, 1939. These resolutions provided for the quarterly dividends on each of the two classes of stock specified so as to reach the amount of four per cent on the one class and 8.60 per cent on the other during the entire year. These dividends were made payable as follows: (1) On March 10, 1939, to stockholders of record on February 24, 1939; (2) on June 10, 1939, to stockholders of record on May 25, 1939; (3) on September 9, 1939, to stockholders of record on August 25, 1939; and (4) on December 9, 1939, to stockholders of record on November 24, 1939.

The first resolution contained a provision that the transfer books should be closed on the record date, to wit, February 24, 1939, and reopened on the morning of March 10, 1939. Each of the last three resolutions contains provisions that the transfer books should be closed

on the record date and reopened two days after the date the dividend was payable.

The amounts of the four dividends were as follows: $360.50, $391.70, $391.70 and $391.70.

WILLIAMS, JUDGE. The question is: Is the executor of Flora K. Wuichet, deceased (who died seized as beneficiary of a life interest in stock of the Little Miami Railroad Company), entitled to dividends declared before her death but payable to stockholders who were of record on a date subsequent to her death?

The contest is between the executor of the deceased owner of the life interest and the trustee of Mary W. Blum, who is referred to in the agreed statement of facts as the remainderman, although the original application for order of distribution sets out that Mary W. Blum has a successive life interest in the stock. Since the contest is over "usual" dividends (that is, ordinary as distinguished from extraordinary dividends), it is not a matter of consequence whether Mary W. Blum claims as successive life tenant or as remainderman. As to ordinary dividends payable out of net current earnings the rule would be the same in either event. The decedent will therefore be referred to as the life tenant and Mary W. Blum as the remainderman.

The general rule is that ordinary dividends declared without proviso during the lifetime of the owner of a life interest in the stock belong to him, regardless of the time they are made payable, and if he dies before payment, the right to them passes to his personal representative.

Here, however, the dividends in question, although declared prior to the death of the life tenant, were payable to stockholders who were of record on days subsequent to the day on which she died, with the proviso that the transfer books of the corporation should be closed on the record date, that is, the day fixed for determining the stockholders of record to whom the dividends were payable.

There is a dearth of authority on the precise point presented. The rule sustained in our judgment by the better reasoning supports the view that where a life tenant dies between the declaration of the dividend and the record date the dividend passes to the successive life tenant or to the remainderman as the case may be. Nutter, Trustee, v. Andrews, Adm'x, 246 Mass. 224, 142 N.E. 67 [Citing cases.] * * *

It should be observed in this connection that there is a close analogy between the situation here and that arising when a stockholder sells his stock, without reservation, between the declaration of the dividend and the record date. In the absence of a specific agreement with reference to the dividend the rule is that on such a sale the dividend passes to the vendee. * * *

That analogy is recognized in the leading case of Nutter, Trustee, v. Andrews, Adm'x, supra, in which, as indicated, was involved the precise question presented in the instant case. In the opinion therein the court says, at page 228 of 246 Mass., at page 68 of 142 N.E.: "It is common knowledge that frequently in the resolution declaring a dividend is also a clause to the effect that the dividend shall be payable to those who are stockholders of record on a specified date. * * * This form of vote in declaring dividends doubtless has been adopted because

of its convenience and because it avoids confusion and misunderstandings. Such vote relates to a detail touching the internal management of the corporation. It belongs to a class of affairs which the corporation has a right ordinarily to settle and thereby bind its stockholders so long as the action taken is in good faith and without fraud or collusion. It is in substance a declaration that the vote for the payment of the dividend shall be operative and take effect as to stockholders on that date and not earlier. There is no inflexible rule of law which prevents such vote of those responsible for the management of the corporation from having its natural effect. Persons by becoming stockholders in a corporation impliedly agree to be bound by the reasonable rules and practices adopted for the management of corporate affairs. Business policies adopted by business men for the management of business transactions ought not to be frustrated unless contrary either to some rule of law or to fundamental ethical rules of right and wrong. Votes as to the time and method for ascertainment of the stockholders entitled to dividends, such as here are in question, do not offend against either of these tests. It is but the logical result of general principles of corporation law to hold that a vote of that nature passed in good faith and reasonable in its operation is binding upon the stockholders. It was so held in a well-reasoned judgment in Richter [& Co.] v. Light [Trustee], 97 Conn. 364, 116 A. 600."

It will be noted that the learned jurist made no distinction between stock owned by a life tenant who dies between the declaration of a dividend and the record date, and stock sold by its owner and holder during that period. That the court regarded the rule as applicable to both situations is emphasized by the citation of Richter & Co. v. Light, Trustee, supra, which involved stock sold in the interim between the declaration and the record date.

The principles, which determine the rights of a life tenant in corporate stock, and to dividends arising therefrom, are well established and fundamental. Accumulated earnings belong primarily to the corporation and prior to the declaration of a dividend therefrom the stockholder has no right to participate in the accumulation as such; but by the declaration the right to the dividend becomes fixed forthwith in the then stockholders regardless of the mere specification of a future date for payment, unless the resolution, in which the declaration is incorporated, provides in effect for a later time of vesting. Accordingly it is necessary to ascertain from the declaratory resolution when and in whom the right vests. If the time of vesting occurs after the death of a person who is owner of a life interest in stock, it is self-evident that he would not be seized of the right at any time. If, on the other hand, the right to a declared and unpaid dividend becomes his during life, and he dies seized thereof, the right survives his death and passes to his personal representative. Upon the vesting of the dividend in the life tenant, he becomes a creditor of the corporation. Until then, of course, no indebtedness is created. When, however, the life tenant dies between the declaration and the record date, no debtor-creditor relationship arises between him and the corporation. The reason is that there is no definitely ascertainable creditor until the record date arrives

and without an ascertained or ascertainable creditor an indebtedness can not subsist. In the last analysis the passage of a resolution declaring a dividend and making it payable to stockholders of record of a named date amounts to a determination that the right to the dividend shall vest on that date.

In the instant case the stock was held by the trustee for the use of Flora K. Wuichet, during her life. On the latter's death, the dividends had previously been declared but had not vested in her trustee for her use. They would therefore pass to the remainderman. In other words the same rule would apply as if the trusteeship had not existed. * * *

For the reasons given the disputed dividends belong to Mary W. Blum, the remainderman, and not to the executor of the estate of Flora K. Wuichet, deceased life tenant.

The judgment is therefore affirmed.

Judgment affirmed.

MARTINDELL v. FIDUCIARY COUNSEL, INCORPORATED.

Court of Errors and Appeals, New Jersey, 1943. 133 N.J.Eq. 408, 30 A.2d 281.

Suit by Virginia P. Martindell against Fiduciary Counsel, Incorporated, and Mildred Martindell, involving right to a dividend on shares of stock, wherein Mildred Martindell filed a counterclaim. From a decree advised by the Vice Chancellor, 131 N.J.Eq. 523, 26 A.2d 171, complainant appeals.

Affirmed.

[Statement of facts from opinion of Vice Chancellor, 131 N.J.Eq. 523, 26 A.2d 171, 172 (1942):

The question is whether complainant or defendant, Miss Mildred L. Martindell, is entitled to a dividend of $100 a share on 27 shares of stock of Fiduciary Counsel, Inc., declared December 30, 1940. The parties had entered into an agreement dated October 25, 1939, which recited their desire that the defendant should have an option to purchase the stock from the complainant: "Now therefore, the seller (complainant) agrees to sell and transfer said 27 shares of stock of Fiduciary Counsel, Inc., to the buyer (defendant) for the price and sum of $5,000 at any time within five years from the date of this agreement."

On December 27, 1940, defendant wrote complainant as follows:

"I hereby exercise the option referred to in agreement between us dated October 25, 1939, and accordingly do hereby demand that you transfer, sell and deliver to me twenty-seven (27) shares of stock of Fiduciary Counsel, Inc. I have deposited the purchase price of Five Thousand Dollars ($5,000) with the Colorado National Bank of Denver, Colorado, to which bank I have given instructions to pay over said sum of Five Thousand Dollars ($5,000) to you or your order against delivery of said shares of stock of Fiduciary Counsel, Inc., duly endorsed and stamped for transfer.

"If you do not accept such procedure for the delivery of said shares and payment of the purchase price, I hereby demand that you designate the time and place for same and I will make payment pursuant to your notice to that effect."

The letter was received by complainant on December 29, and the next day the directors of Fiduciary Counsel, Inc., declared the dividend. On January 3, complainant acknowledged receipt of defendant's letter. She was unwilling to conclude the transaction in the manner suggested by defendant, but stated that she would be ready to deliver the stock against legal tender in the amount of $5,000 at a certain hour and place in New Jersey. The stock was transferred and the consideration paid early in February.]

HEHER, JUSTICE. * * * A dividend declared on corporate capital stock during the pendency of a mere option to purchase the shares inures to the transferor, even though payable in futuro. But if there be no provision otherwise, a dividend declared on shares constituting the subject of a binding executory contract of sale, after the making of the contract and before the consummation of the sale, is the property of the transferee. Equity regards and treats as done what in good conscience ought to be done. * * *

Shares of capital stock are "personal property." R.S.1937, 14:8–12 N.J.S.A. 14:8–12. And dividends thereon constitute a portion of the accumulated surplus or profits of the enterprise allotted to the stockholders according to their several interests, as their distributive property. R.S. 14:8–19 and 14:8–20, N.J.S.A. 14:8–19, 14:8–20. Upon declaration, the dividend becomes instanter the property of the shareholder, although payable in the future. It is separate and distinct from the stock, and does not pass as an incident of the shares if sold before the payment of the dividend. But prior to the declaration of the dividend, the stockholder's right to share in the corporate surplus or profits is an incident of his stock ownership and is included in a sale of the shares. Ford v. Snook, 205 App.Div. 194, 199 N.Y.S. 630, affirmed 240 N.Y. 624, 148 N.E. 732. By the same token, this right to participate in a distribution of surplus or earnings among the shareholders is an incident of the beneficial ownership of shares made the subject of an executory contract of sale, and a dividend intervening the making of the contract and the consummation of the sale passes to the holder of the equitable title to the stock and is an interest cognizable and enforceable in equity. Such is the equitable conception of right and duty barring provision otherwise. The equitable obligation is designed to fulfill the common intention of the parties. In these circumstances, it is deemed that the parties contemplated the transfer of the shareholder's interest in the corporate property as it subsisted when the contract of sale was made. This is the element of value that measures the sale price. That interest undiminished by the subsequently declared dividend was the thing bargained for. To borrow the metaphor of the opinion in La Fountain & Woolson Co. v. Brown, 91 Vt. 340, 101 A. 36, L.R.A.1917F, 551, equity permits the vendor to retain the "fallen fruit," but it does not grant to him the additional privilege of "shaking the tree" after the bargain is closed.

Shares of stock represent the holder's interest in the corporate assets, and their transfer serves to convey that interest. The surplus of a corporation is an integral part of the stock itself until separated from the capital by the declaration of a dividend. In re Heaton's Estate, 89

Vt. 550, 96 A. 21, L.R.A.1916D, 201. "Such undivided surplus will pass with the stock under that name in a transfer thereof. The purchaser takes the stock with all its incidents, one of which is the right to receive its proportionate share of undivided profits." La Fountain & Woolson Co. v. Brown, supra [91 Vt. 340, 101 A. 37, L.R.A.1917F, 551]. Under an executory contract of sale, there being no different intent, the vendor's beneficial interest passes to the vendee immediately the contract of sale is made. The Uniform Stock Transfer Law, R.S.1937, 14:8–23, et seq., N.J.S.A. 14:8–23 et seq., has no applicancy to transfers of an equitable title; it governs the conveyance of the legal title only. Stuart v. Sargent, 283 Mass. 536, 186 N.E. 649.

Thus, if there be no stipulation to the contrary, the vendee under an executory contract of sale of corporate stock is entitled in equity, on the performance of his contract, to a dividend declared on the shares subsequent to the making of the contract.

As stated, equitable ownership is not effective for all purposes. For example, it is the general rule that, unless there be a statutory provision or a stipulation contrariwise, an executory contract for the sale of capital stock does not deprive the holder of the legal title of his right to vote thereon at stockholders' meetings. In re Argus Co., 138 N.Y. 557, 34 N.E. 388; 18 C.J.S., Corporations, § 548, p. 1239. Vide R.S. 1937, 14:10–1, et seq., N.J.S.A. 14:10–1 et seq.

There is no superior equity in favor of the optionor here which serves to vary the application of the general rule. Indeed, there is no such contention.

Let the decree be affirmed.

D. PREFERRED STOCK [1]

"Whatever preferential rights and privileges may thus be granted to a stockholder, the law regards them as contractual. 'The certificate of stock is the muniment of the shareholder's title, and evidence of his right. It expresses the contract between the corporation and his co-stockholders and himself.'" Strout v. Cross, Austin & Ireland Lumber Co., 283 N.Y. 406, 28 N.E.2d 890, 1940, *infra* p. 531.

In many states, the articles or certificate of incorporation is the sole source of the terms of the preferred share contract and the by-laws, stock certificates or corporate resolutions cannot add to or alter those terms. Gaskill v. Gladys Belle Oil Co., 16 Del.Ch. 289, 146 A. 337, 1929. But many courts have looked not alone to the charter, but to the stock certificate, the by-laws and all resolutions, notes or proceedings under which the shares were issued. Continental Ins. Co. v. United States, 259 U.S. 156, 42 S.Ct. 540, *infra* p. 569; Scott v. Baltimore & Ohio R. R. Co., 93 Md. 475, 49 A. 327, 1901.

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1 On preferred stock, see: Berle, Studies in the Law of Corporation Finance, 1928, c. VI; Dewing, The Financial Policy of Corporations, 4th Ed., 1941, Vol. I, c. 7; Grossman, Corporate Securities—Especially Common and Preferred Stocks, 1931, 17 A.B.A.J. 123; Notes, Right of Holders of Preferred Stock in Respect of Dividends, 1930, 67 A.L.R. 765; 1935, 98 A.L.R. 1526; The Controlling Effect of Articles of Incorporation Over Share Certificates, 1924, 24 Col.L.Rev. 177; 1925, 11 Corn.L.Q. 230; Preferred Stock as an Investment Security, 1939, 28 Geo.L.J. 232; 1938, 22 Minn.L.Rev. 676; 1936, 23 Va.L.Rev. 189.

See N. Y. Stock Corp. Law, § 11, *supra* 223; Del. Gen. Corp. Law, § 13, *supra* 224.

The preferred shareholders are members of the company and except in so far as their rights may be altered by their contract under which the shares are issued, they are entitled in all respects to the same rights as the common shareholders. General Inv. Co. v. Bethlehem Steel Co., *infra*, p. 593.

NEW YORK STOCK CORPORATION LAW, § 11. *Preferred and Common Shares, supra,* p. 223.

DELAWARE GENERAL CORPORATION LAW, § 13. *Classes of Stock, supra,* p. 224.

NOTE

PREFERRED STOCK AS A SUBSTITUTE FOR BONDS OR NOTES

(A) Financially, preferred stocks are at present used by corporations as the lowest grade of security by which money can be obtained at a fixed price.

The law regards the preferred shareholder as a shareholder for all purposes. The corporation, on the other hand, is much more apt to regard him as a substitute for a bond or note holder. When capital is desired, and it is not wished to sell a full participation, i. e. common stock, a discussion normally goes on as to whether the corporation will issue bonds or preferred stock.

A modern preferred stock is practically always "redeemable," i. e., the corporation can pay off the holder of it at a stipulated price and eliminate him from the picture. It commonly bears a fixed dividend right and is commonly limited so that it will receive only a stated amount in case the corporation is liquidated or wound up. None of these elements is necessarily present. Preferred stock may also be secured by various means as, for instance, by a sinking fund carved out of profits.

The law draws a sharp distinction between the stockholder or participant in profits, and the bondholder who is a creditor. It is questionable whether financially this distinction is justified. The bondholder and the preferred stockholder both will collect their interest or dividends and ultimately be paid off, if, but only if, the management is reasonably able and faithful. On the other hand, neither the one nor the other has a vivid personal interest in seeing the corporation tremendously successful, since neither will profit largely by that success. Both, however, have their money so involved in the corporation that it cannot be repaid except after a considerable period of time.

Financially preferred stock is useful because

(a) non-payment of dividends does not entail foreclosure or winding up of the corporation;

(b) repayment of the investment does not fall due at any given time, the redemption feature being commonly an option only on the part of the corporation;

(c) it permits the corporation to borrow money on a note or bond which will be collected out of the assets before the preferred shareholder secures anything, thus leaving the corporation an additional credit resource.

At present, it is the banking cliché that the average industrial company can market a preferred stock provided it shows earnings in excess of three times the dividend requirements on its preferred issues. This varies: a stable company like a water works can sell preferred stock with less earnings; a hazardous business such as a mine will have difficulty in selling preferred stock, whatever its earnings.

(B) "* * * actually (the preferred stockholder) is an investor, almost entirely disassociated from the management of the corporation and primarily interested in the security and monetary return of his investment. What protective devices have been allowed by the courts to safeguard the investment is thus a question of primary importance. Some of the more significant provisions which have been embodied in the certificates of preferred stock are; (i) devices to insure payment of dividends; (ii) devices to secure redemption, and the closely allied

device to assure priority in the distribution of assets upon dissolution; (iii) devices for protection against future incumbrances; (iv) devices to assure a share in the management of the corporation." Note, 1927, 27 Col.L.Rev. 587. A further protective device is illustrated by a North Carolina statute which permits the holders of one-fifth of the corporation's paid-up stock to petition for dissolution if the corporate net earnings for three successive years are insufficient to pay an annual 4% dividend. Note, Statutory Protection of Preferred Stockholders, 1934, 43 Yale L.J. 1196.

TENNANT v. EPSTEIN et al.

Supreme Court of Illinois, 1934. 356 Ill. 26, 189 N.E. 864.

Suit by Thomas R. Tennant against Harry Epstein and others. From a judgment of the Appellate Court (271 Ill.App. 204) reversing a decree of the circuit court for complainant, he appeals.

Reversed, and decree of the circuit court affirmed.

FARTHING, JUSTICE. This cause comes here from the Appellate Court for the Second District by appeal and certificate of importance. That court reversed a decree of the circuit court of Lake county without remanding the cause.

The appellant, Thomas R. Tennant, filed a bill in equity in July, 1929, in the Lake county circuit court, against the appellees Harry Epstein, Anna Epstein, his wife, Chester H. Epstein, their son, and the Grayslake Gelatine Company, an Illinois corporation. The bill prayed for cancellation of 32,000 shares of common stock which formed a stock dividend, for repayment of cash dividends thereon, and, in the alternative, for relief not in question in this court. * * * The question presented by this record is whether the holders of preferred stock in this company have a right to share in a stock dividend to be paid for out of the undivided earnings and surplus in addition to the 7 per cent. annual cash dividend. The preference which preferred stock enjoys over common stock as to dividends is entirely a matter of contract. The contract is generally set forth in the charter or articles of incorporation, by-laws or stock certificates. No case has been found from our own jurisdiction bearing upon the point of the right of preferred stock to share in dividends beyond the amount of preference stated. Decisions of other jurisdictions are helpful only to the extent that the language contained in the contract between the shareholders is similar to that under consideration here and if the statutes there are similar to our own. * * *

It is elementary that the statute in force when the contract between the shareholders was made is a part of their contract. Where no statute exists, the contract itself is all that need be looked to to determine the preferential rights of preferred stockholders. Williams v. Renshaw, 220 App.Div. 39, 220 N.Y.S. 532. At the time the contract contained in the articles of incorporation in this case was entered into between the parties to this suit, the act in force was the act of 1919 as amended in 1921 (Smith-Hurd Rev.St.1931, pp. 743, 745, c. 32). Sections 6 and 31 (Smith-Hurd Rev.St.1931, c. 32, §§ 6, 31) provide, respectively, what shall be included in the articles of incorporation and stock

certificates. Paragraph 4 of section 6 provides that each corporation organized under the act shall, subject to the conditions and limitations prescribed by the act, have the following powers, rights, and privileges: "To have a capital stock of such an amount, and divided into shares with a par value, or without a par value, and to divide such capital stock into such classes, with such preferences, rights, values and interests as may be provided in the articles of incorporation," etc. Section 31 provides: "Shares of stock having a par value shall be represented by certificates which shall state the number of shares represented thereby, the par value thereof, the name of the holder, the relative rights, interests and preference (if any) of such shares," etc. These provisions of the statute clearly limit the rights, preferences, and interest of preferred as well as common shareholders to what is set out in the articles of incorporation and the stock certificates. In addition to statutory provisions, the rule of construction has been generally adhered to that expressio unius est exclusio alterius. Stone v. United States Envelope Co., supra; Ramsey v. Steel Co. of Canada, 4 D.L.R. (Ont.) 879; Lyman v. Southern Railway Co., 149 Va. 274, 141 S.E. 240.

What, then, did the parties here intend? Epstein's attorney, who drew up the articles of incorporation, the stock certificates, and bylaws, testified that the declaration of a stock dividend was not contemplated at the time the corporation was organized. We are left to determine what the parties must have meant from a consideration of the language they used, the circumstances surrounding the parties, and their conduct. Continental Ins. Co. v. United States, 259 U.S. 156, 42 S.Ct. 540, 66 L.Ed. 871. Before the corporation was formed, Epstein told Tennant that the profits on 25 per cent. of the common stock would double his salary of $1,000 per month. Moses testified that Tennant was very insistent that the preferred stock should yield a return of 7 per cent. and should be cumulative, so that he could pay interest on the $10,000 he had borrowed for the purpose of buying the preferred stock. These objects were expressed when the corporation was formed. The articles gave the preferred stock a first lien on the assets of the company in the event of dissolution and a preference of 7 per cent. cumulative dividend before any dividend should be declared upon the common stock. The stock certificates stated that the preferred stock should receive from the surplus or net earnings of the corporation dividends at the rate of 7 per cent., and no more. That would seem to be a complete delimitation of the rights of the preferred stock. It certainly negatives an equal distribution of the surplus of the company after the payment of the preferred dividend.

We think the results reached in Stone v. United States Envelope Co., supra, Niles v. Ludlow Valve Manf. Co. (C.C.A.) 202 F. 141, Id., 231 U.S. 748, 34 S.Ct. 320, 58 L.Ed. 465, and Will v. United Lankat Plantations Co., [1914] A.C. 11, cited in 67 A.L.R. 775, are more nearly in accord with business usage and the expectation of investors when they purchase preferred shares of stock. In Will v. United Lankat Plantations Co., supra, Earl Loreburn, speaking for the House of Lords, said that a general assumption is well founded that, where preference shares are given and a definite preferential dividend is fixed,

"that impliedly negatives any right to take any further dividend." It was contended that the rights of preference shareholders ought not to be cut down except where something is found which negatives the right to any further share in the profits. He remarked that people taking the preference shares would doubtless have been surprised to learn that they were to receive the "almost boundless additional advantages which have been held out to them in the arguments we have been hearing," and that it was really an attempt to add to the terms of the contract "by screwing something out of the articles which the framers of the contract, I do not believe, ever thought of." * * * We think the reasoning of these cases applies here. The preferences stated in the stock certificates are a delimitation of the rights of the preferred stockholders.

Another act adverse to appellees' contention is found in the payment of the 49 per cent. dividend on the value of the 2,000 shares of common stock in 1929 and the payment of but the limited 7 per cent. on the value of 30,000 shares of preferred stock in that year prior to the stock dividend. Appellees contend that by payment of this "equalizing" dividend the case of Stone v. United States Envelope Co., supra, is rendered inapplicable, but cite Englander v. Osborne, 261 Pa. 366, 104 A. 614, 6 A.L.R. 800, where it is said: "We find nothing limited the right of the preferred stockholders to the 6 per cent. dividend regardless of the earnings of the company, and in absence of such limitation the general rule is that such stockholders are entitled to share with the holders of the common stock all profits distributed after the latter have received in any year an amount equal to the dividend on the preferred stock." If this rule of law quoted by appellees is correct, the preferred stock should have had a dividend in 1929 of 49 per cent. instead of 7 per cent., "and no more," as provided in the stock certificates. What was paid on the preferred stock shows the interpretation by the parties of their rights and privileges as expressed in the articles of incorporation.

The position of the appellees is that the preferred stockholders are as much parties to the business venture as the common stockholders and are entitled to all the rights of the common stockholders except as modified by statute and contract. Star Publishing Co. v. Ball, supra; Englander v. Osborne, supra. In other words, they say that the preferences contained in the articles and the stock certificates are merely delimitations of the preferences and not of the rights of the stockholders. The effect of this would be to make the preferred shares participating when no mention of such a right or interest is contained in the articles of incorporation. The parties had the duty, under the law, to provide for this additional right if they intended to create it.

It is contended that the by-law which gave all stockholders equal right to subscribe to new stock at not less than par entitled appellees to share in the stock dividend. The answer to this is, that the act requires the rights, privileges, and interests to be set out in the articles of incorporation and to be again contained in the stock certificates. The contention is also made that what is said in the stock certificates is not controlling, but that, since the words "no more" are not found

in the articles, while they do appear in the certificates, this gives the right to share in a stock dividend to preferred stockholders. For the same reasons this contention is unsound. What the parties did was to interpret and construe the meaning of the articles of incorporation by expanding what was said therein. The obvious purpose of having articles of incorporation and requiring by statute the statement of rights, privileges, etc., therein and in stock certificates, is to make convenient and certain the necessary information as to these matters for the use and protection of the investing public.

Cases involving income taxes and the construction of wills are cited to the effect that stock dividends are not dividends of cash. While this is true, the holders of the majority of the stock in this company cannot do indirectly what they cannot do directly. They cannot, by a stock dividend based upon a by-law intended to cover the situation which would arise if new capital were required, create a right to additional cash dividends in the holders of preferred stock, to the plain detriment of the appellant as one of the holders of the original common stock.

It is strongly urged, first, that, since no mention is made of the distribution of surplus assets in case of dissolution, the holders of preferred stock would be entitled to share pro rata with holders of common stock after principal and dividends were paid on the preferred stock and a like payment of principal and dividends on common stock. From this it is urged, secondly, that the holders of preferred stock should share in the division of a present surplus executed through the medium of a stock dividend. For two reasons this is illogical and unsound: First, it was not necessary in the stock certificates to use the words "no more" to limit payment of dividends to seven per cent per annum; second, the so-called "consistency rule" does not permit appellees, who are a majority in voting power, to withhold dividends on common stock, pile up a surplus, indefinitely vote a stock dividend to themselves not provided for in the articles of incorporation, and thus deprive the holders of common stock of cash dividends they might have received had these things not been done. The purpose is obvious when it is recalled that cash dividends on all common stock were declared after the stock dividend.

It is strenuously argued that the stock dividend should be allowed to stand because, if declared pro rata, it would effect no change in voting control. While this is true, it very materially changes a more important right, viz., the right to dividends if and when declared. If the rights were as contended by appellees, it would be pertinent to ask. Why would any one invest $10,000, or any other sum, in common stock in this company? In Cratty v. Peoria Law Library Ass'n, 219 Ill. 516, 76 N.E. 707, we recognized the rule that, while the directors of a corporation are given a wide discretion as to the question of declaring dividends, yet, if this discretion is abused, or if they act in bad faith or in an arbitrary manner, a holder of common stock may ask the aid of equity to compel the declaration of a dividend. There can be no question that in the opinion of the majority of the stockholders all the surplus was not needed. A dividend would not affect the voting control. No necessity for a stock dividend is shown. Immediate declaration of

cash dividends followed the stock dividend. The cash dividends to the holders of preferred stock were increased, and this was the only end served. In the contract no stock dividend was provided for as to holders of preferred stock. The question, therefore, of voting control is not properly involved in the case, but the question of cash dividends, and the right thereto if cash dividends be declared, is here for a determination. We are aware of the authorities, both of cases and text-writers, which indicate that the element of consideration of voting control makes it necessary that stock dividends be distributed pro rata among all shareholders where nothing to the contrary is contained in the contract. In our opinion, the authorities mentioned do not control in this case, in view of the statute of this state in force when the corporation was organized, the articles of incorporation, the stock certificates' recitals, and the construction given the contract by the stockholders, who are the same persons now as were the original shareholders.

For the reasons indicated, the judgment of the Appellate Court is reversed, and the decree of the circuit court of Lake county is affirmed.

Appellate Court reversed, circuit court affirmed.[3]

NOTE

If the charter or certificates expressly provide what shall be the respective shares of the preferred and common stockholders in any surplus, their terms will be followed by the courts. Courts have worked out several rules to be applied in cases in which the contract is not specific. In addition to the rule laid down in Scott v. The Baltimore & Ohio Railroad Co. (cited supra, p. 499) there is the so-called "Pennsylvania" rule, which provides that: "In the absence of such limitation (limiting the rights of preferred stockholders to a 6% dividend regardless of the company's earnings) the general rule is that such (preferred) stockholders are entitled to share with the holders of the common stock all profits distributed after the latter have received in any year an amount equal to the dividend on the preferred stock." Englander v. Osborne, 261 Pa. 366, 368, 104 A. 614, 6 A.L.R. 800, 1918. A third possible rule which might be applied would be first to pay the preferred its stated dividend, then divide the balance equally between the preferred and common stockholders, without first giving the common stockholders an equal dividend with the preferred. This rule does not seem to have been adopted by any court. On the rights of preferred stockholders to share in corporate surplus, see, Christ, Right of Holders of Preferred Stock to Paticipate in the Distribution of Profits, 1929, 27 Mich.L.Rev. 731; Rowell, Rights of Preferred Shareholders in Excess of Preference, 1935, 19 Minn.L.Rev. 406 (disagrees with the point of view taken by Christ); Thompson, Respective Rights of Preferred and Common Stockholders in Surplus Profits, 1921, 19 Mich.L.Rev. 463; Notes, 1925, 11 Corn.L.Q. 234; 1937, 12 St.John's L.Rev. 108; 1931, 79 U. of Pa.L.Rev. 466; 1931, 31 Col.L.Rev. 164; 1930, 29 Mich.L.Rev. 250; 1935, 33 Mich.L.Rev. 968; 1933, 81 U. of Pa.L.Rev. 875.

[3] Note, 1934, 2 U. of Chi.L.Rev. 133; 1935, 33 Mich.L.Rev. 439; 1935, 19 Minn.L. Rev. 239; 1934, 83 U. of Pa.L.Rev. 91.

1. PREFERRED STOCK: PRIORITY DISTINGUISHED FROM DEBT

HAZEL ATLAS GLASS CO. v. VAN DYK & REEVES, Inc.
VAN DYK v. YOUNG.

Circuit Court of Appeals of the United States, Second Circuit, 1925.
8 F.2d 716.

Appeal from the District Court of the United States for the Eastern District of New York. Creditors' suit by Hazel Atlas Glass Co. against Van Dyk & Reeves, Inc.

[In 1921 a partnership to manufacture and deal in food products was formed by Edmond Van Dyk, Benjamin Reeves and Marion Ellis. The partnership was dissolved and its property and assets assigned to a corporation formed in July, 1922 by the copartners. Van Dyk's property in trade-marks, names and labels was valued at $45,000. $45,000 of common stock was issued to Reeves and Ellis and deposited by them in escrow to secure a $45,000 note made by them to Van Dyk in January, 1922. This note was exempted from the partnership liabilities assumed by the corporation and remained the personal obligation of Reeves and Ellis.

In July, 1922, Van Dyk, Reeves and Ellis entered into an agreement whereby Van Dyk was to receive $45,000 par value of the 100,000 preferred shares of the corporation; this stock was to receive a 10% cumulative dividend; it was to have no vote unless three dividends remained unpaid, then to have an equal vote with the common stock until all preferred dividends were paid; Reeves and Ellis were to pay Van Dyk any dividends unpaid by the corporation, and, upon so doing, the three parties waived any right to vote the preferred shares; if Reeves and Ellis failed to make good the amount of any dividend, Van Dyk could demand, on 30 days' notice, that the corporation redeem his stock at par; if the corporation failed to redeem it, Reeves and Ellis must. It was further agreed that the corporation redeem the preferred stock at par on or before January 1, 1932; if it failed to do so, Reeves and Ellis would purchase the stock at par on demand from Van Dyk; further, Reeves and Ellis might purchase the stock at par at any time.

As additional collateral for payment of the debt to Van Dyk and redemption of his preferred stock, $43,200 of common stock was deposited in escrow, to be held until the preferred was redeemed or bought at par. If the preferred was not redeemed or purchased, Van Dyk might foreclose the collateral and have it sold with so much of his preferred stock as had not yet been redeemed or purchased, pursuant to court order.

The corporation agreed to issue the preferred stock, pay dividends on it, purchase and redeem it on the above terms, with Reeves and Ellis as guarantors. With Van Dyk's consent, the corporation imposed the following conditions on the preferred stock issued to him: (1) the stock was to be left in the hands of Van Dyk's attorney in

fact; (2) it was not to be taken out of New York state; (3) Van Dyk could not dispose of it except by redemption, sale to Reeves and Ellis, or sale under court order; (4) the terms of the agreement under which the stock was issued were to be stamped on each certificate; (5) if Van Dyk received more than par for the stock (*i. e.,* by a sale at public auction pursuant to court order and there was a surplus) the surplus was to be paid to Reeves and Ellis, who agreed that, if less than par should be realized on such sale, either they or the corporation would make good the deficiency.

The corporation went into receivership; Van Dyk filed his claim as a creditor; from an order holding him not a creditor entitled to file a claim against the corporation, he appeals.]

ROGERS, Circuit Judge (after stating the facts). A receiver was appointed for the corporation in the usual creditors' suit. In due course the receiver moved the court for an order expunging a claim filed by appellant herein on the ground that he had no provable claim against the Van Dyk corporation—being a stockholder therein and not a creditor. This is an appeal from that order, and the sole question is whether this appellant is in law a creditor of the corporation.

The corporation agreed that the preferred stock should be entitled to cumulative dividends at the rate of 10 per cent. per annum, payable in equal monthly installments. Under such an agreement the corporation was legally bound to pay these dividends out of profits. If it had expressly agreed to pay them out of its capital, the agreement would have been unlawful and void. * * *

The general rule is that a holder of preferred stock, even though the preferred dividend is guaranteed, is not regarded as a creditor of the corporation, and entitled as such to share with the other creditors in the distribution of the assets. He is, like the holders of the common stock, merely a stockholder, but with this difference, that he is entitled to priority of payment out of the assets which remain after all debts are paid; the holders of the common stock sharing in such assets as are left. * * *

The rights which the holder of preferred stock has depend upon his contract with the corporation. The rule is that preferred stockholders are entitled to vote the same as the common stockholders, unless by the terms of its issue the voting power has been expressly withheld. But the fact that Van Dyk, as the holder of the preferred stock, was to have no right to vote it, except in the event that three dividends should remain unpaid, and thereupon should have equal voting rights with the holders of the common stock until all dividends on the preferred stock were paid, is a matter of no consequence, so far as the legal question herein involved is concerned. It does not change Van Dyk's status from that of a preferred stockholder into that of a creditor. * * *

We have already pointed out that the agreement which the corporation made to redeem the stock and to pay dividends at 10 per cent. per annum in equal monthly instalments did not change the relation of Van Dyk to the corporation from that of a stockholder into

that of a creditor, and that all that was meant was that redemption and dividend payments were to be made only out of surplus. It could not lawfully have agreed to redeem or to pay dividends out of capital. The same construction must be placed upon this agreement to be liable for a deficiency resulting from the foreclosure sale. It must be understood that this liability for any deficiency is limited to the liability originally assumed by it. We have seen that that liability did not extend beyond redeeming from its surplus and paying dividends from its surplus. * * * Order affirmed.[3]

NOTE

(A) "While * * * the claim of the holders of the preferred stock against the corporation is not strictly a debt, but is contingent upon the existence of sufficient net profits to pay it, it is evident that preferred stock is only a security for a loan, upon which a certain and definite interest was to be paid while the corporation existed, and the full amount thereof returned to the lender when it was dissolved, before the holders of the common stock should receive anything. * * * about the only difference between him and the ordinary lender of money was that he was not to receive his interest unless there were sufficient net profits to pay the same. Therefore, so far as the face value of the preferred stock is concerned, it is in the nature of a debt against the corporation, and the interest thereon becomes a debt as soon as it can be shown that there were profits wherewith to pay it, and becomes a lien prior to the rights of the holders of common stock upon the net earnings, if there were such, for the amount of the dividend, and can be followed wherever invested by the company." Storrow et al. v. Texas Consolidated Compress & Manufacturing Ass'n, 87 F. 612, 616–617, C.C.A.Tex.1898, cert. denied, 174 U.S. 800, 19 S.Ct. 887, 43 L.Ed. 1187, 1898. See, also, Note, 1939, 123 A.L.R. 856; 1913, 13 Col.L.Rev. 545; 1930, 28 Mich.L.Rev. 764.

(B) The exercise of an option given preferred stockholders to convert their shares into corporate bonds does not give them a preference over corporate creditors in bankruptcy proceedings. 1936, 34 Mich.L.Rev. 1041.

LLOYD et al. v. PENNSYLVANIA ELECTRIC VEHICLE CO.

Court of Errors and Appeals of New Jersey, 1909.
75 N.J.Eq. 263, 72 A. 16, 21 L.R.A.,N.S., 228, 138 Am.St.Rep. 557, 20 Ann.Cas. 119.

SWAYZE, J. The question involved in this case is the distribution of a surplus remaining in the hands of the trustees in liquidation of the Pennsylvania Electric Vehicle Company after payment of the debts. The controversy is between the preferred stockholders, whose claims will absorb the whole surplus in case they are entitled to a preference in the distribution, and the common stockholders. The vice-chancellor decided in favor of the preferred stockholders.

The question to be decided is one of contract, and the contract of the preferred and common stockholders inter sese is determined by the provisions of the statute and of the certificate of incorporation. The sections of the statute [P.L.1896, p. 277] that are material to the inquiry are sections 8, 18, and 86.[4]

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[3] Cert. denied, 269 U.S. 570, 46 S.Ct. 26, 70 L.Ed. 417, 1925.

[4] *Cf.* N.J.S.A. 14:2–3: "The certificate of incorporation shall set forth: * * * e. * * * if there be more than one class of stock created by the certificate, a descrip-

Section 8, as amended in 1898 (P.L.1898, p. 408), requires that the certificate of incorporation shall set forth the amount of the authorized capital stock, the number of shares into which the same is divided, and the par value of each share, and if there be more than one class of stock created by the certificate of incorporation, a description of the different classes, with the terms on which the respective classes of stock are created.

Section 18 authorizes every corporation organized under the act to create two or more kinds of stock, of such classes, with such designations, preferences and voting powers or restrictions, or qualifications thereof as shall be stated and expressed in the certificate of incorporation, or in any certificate of amendment thereof. It provides that at no time shall the total amount of the preferred stock issued and outstanding exceed two-thirds of the capital stock paid for in cash or property, and such preferred stock may, if desired, be made subject to redemption at any time after three years from the issue thereof at a price not less than par, and the holders thereof shall be entitled to receive, and the corporation shall be bound to pay thereon, dividends at such rates and on such conditions as shall be stated in the original or amended certificate of incorporation, not exceeding eight per centum. It also provides that in case of insolvency, the debts or other liabilities shall be paid in preference to the preferred stock.[5]

The provision of the certificate of incorporation, as amended, is as follows:

"Forty thousand of said shares are to be preferred stock, the holder thereof to receive, and the company to pay, a fixed yearly dividend of six per cent. before any dividend shall be set apart or paid on the general stock."

The company was organized in 1899, pursuant to the act of 1896 [P.L. p. 277.]

Section 86 of the present act, N.J.S.A. 14:14–23, is substantially the same as section 80 of the act of 1875 [Revision 1877, p. 191]. Sections 8 and 18, N.J.S.A. 14:2–3, 14:8–1 to 4, introduced new provisions, in that the former requires that the certificate of incorporation shall contain a description of the different classes, with the terms on which the respective classes of stock are created, in case more than one class of stock is created by the certificate; and the latter, which takes the place of section 25 of the act of 1875, authorizes the creation of more than two kinds of stock, with such designations, preferences

tion of the different classes with the terms on which created; * * *"; 14:8–2: "The holders of preferred or special stocks shall be entitled to receive dividends at such rates, on such terms, and at such times as shall be provided in the certificate of incorporation * * * and such dividends may be made cumulative. Such holders shall be entitled to such rights upon the dissolution of or any distribution of the assets of the corporation as shall be expressed in the certificate of incorporation. * * *"

5 N.J.S.A. 14:13–8: "The trustees or receivers shall pay ratably, as far as its moneys and property shall enable them, all the creditors of the corporation who prove their debts in the manner directed by the court. If any balance remains after the payment of the debts and necessary expenses, the same shall be distributed among the stockholders."

Cf. N.Y.General Corporation Law, § 29.

and voting powers or restrictions or qualifications thereof as shall be stated and expressed in the certificate of incorporation.

It has been held, and may be regarded as entirely settled, that calling stock "preferred stock" does not of itself determine the rights of the holders, for the extent of the preference is to be determined by the terms of the contract. McGregor v. Home Insurance Co. of Newark, 33 N.J.Eq. 181; Elkins v. Camden & Atlantic Railroad Co., 36 N.J.Eq. 233.

It was also said, upon equally good grounds in the McGregor Case, that preferred stock, in the absence of an express stipulation or direction to the contrary, simply gives the holder a right of preference in the division of profits, and not in the distribution of capital. The learned vice-chancellor cited as authority the opinion of Vice-Chancellor Maline in the case of In re London India Rubber Co., L.R. 5 Eq. 519; 37 L.J.Eq. 235, and of Sir George Jessel in Griffith v. Paget, L.R. 6 Ch.Div. 511; 46 L.J.Eq. 493. It was, however, held in the McGregor Case that the terms of section 80 of the act of 1875, now section 86, required that the preferred stockholders should be preferred in the distribution of assets upon insolvency. It is unnecessary to consider whether the opinion of the vice-chancellor in this respect was, as Mr. Cook says (Cook Corp. § 278, note), a mere dictum. We are satisfied that it has been acted upon as a correct statement of the law of the state, and that, if the legislature, in the revision of the Corporation act in 1896, had done no more than reenact this provision, it would be necessary to hold that they had adopted the construction which had been put upon the section sixteen years before. This, however, is not the situation presented by the act of 1896, for that act contained the provisions in section 8 and in section 18, that we have quoted. The insertion of those provisions in the act indicates an intent upon the part of the legislature to make some changes in the then existing law. We think the change that they intended was to require that all preferences or special privileges to be conferred upon any class of stock be set forth in the certificate of incorporation. * * * The power to create preferred stock is granted by section 18, and it is granted upon the terms set forth in that section. To enact that the stock should have such preference as is stated or expressed in the certificate was equivalent to enacting that it should have no other preferences upon the general principle of interpretation that the expression of one thing is the exclusion of another. The very fact that section 18 provided for more than one class of preferred or special stock leads to the same conclusion, for it can hardly be claimed that the rights of more than one kind of preferred stock would be determined by the language of section 86 standing alone. That section is a survival of legislation going back to the early days of corporations in this state, at a time when only one class of preferred stockholders was authorized. Such is not now the case. Under the present act it is possible, for example, to issue what are called sometimes "founders' shares." Unless the rights of such shares are determined by the certificate of incorporation, they cannot be determined by the provisions of section 86, and the same reasoning is ap-

plicable to other classes of shares (aside from the ordinary preferred shares) which are issued by modern corporations. We recognize the necessity of construing the several sections of the act so as to give effect to each and to all the language of each. We think that can well be done. Section 86 is still necessary, notwithstanding the changes made in 1896, in order to cover the case of corporations existing under special charters, or corporations under the general acts prior to 1896. A greater difficulty, perhaps, is presented by the provision of section 86, that the surplus funds after payment of creditors, costs, expenses and allowances and the preferred stockholders, shall be paid to the general stockholders proportionally according to their respective shares. It requires no strained construction, however, to hold that this provision as to the payment of preferred stockholders in preference to the general stockholders is a payment to them not of the par value of their stock but of the amount to which they are entitled as a preference by virtue of the contract contained in the certificate of incorporation. Section 86 does not say that the preferred stockholders shall be paid the par value of their stock with the unpaid dividends that may have accrued thereon. It requires only that the preferred stock shall be paid in preference to the general stockholders, and that means that they shall be paid so much, and so much only, as their contract gives them. The amount of the surplus to be paid to the general stockholders is not necessarily the amount that may be left after paying the preferred stockholders the par value of their stock. It may just as well mean the surplus that is left after paying them the amount to which they are entitled by their contract. Nor is any difficulty presented where the terms of the contract entitle the preferred stockholder to a preference in dividends only. In this case which, as Vice-Chancellor Van Vleet said, and as the authorities show, was the ordinary case in the absence of such a provision as that contained in section 86, the preferred stockholders and the general stockholders would share pro rata in the distribution of assets after the payment of dividends due the preferred stockholders. * * * We see no reason why, if the case is ever presented, the same rule should not be applicable under section 86, and the amount to be paid to the preferred stockholders in such a case would be, first, what they were entitled to under the certificate of organization, and second, their proportional share of the remaining assets. The surplus, after making that payment, would, by the terms of section 86, belong to the general stockholders. * * *

It is important that investors in a corporation should be able to ascertain their rights by an examination of the certificate, and it was no doubt with that end in view that the legislature made the changes in the act of 1875, which now appear in section 8 and 18. It is true, as was forcibly argued on behalf of the respondents, that it can hardly be that all of the rights of preferred stockholders need be set forth in the certificate of organization, but this fact does not require that we should hold that the certificate of organization cannot limit such rights. Manifestly it can, for if it were not so it would be beyond the power of the incorporators to take away the right to a preference on

distribution of assets conferred by section 86. Since the corporators have this power to limit the rights of preferred stockholders, the question in any particular case is whether they have in fact done so. When they have undertaken, as in this case, to set forth the preference to which preferred stock is entitled, we think that they must set forth that preference fully, and that, so far as they fail to express a preference, the preferred stock can have no other rights than the common stock.

The decree must be reversed, with costs, and the records remitted to the court of chancery for further proceedings therein in conformity with this opinion.[6]

COMMISSIONER OF INTERNAL REVENUE v. MERIDIAN & THIRTEENTH REALTY COMPANY.

Circuit Court of Appeals of the United States, Seventh Circuit, 1942. 132 F.2d 182.

Petition by the Commissioner of Internal Revenue to review a decision of the Board of Tax Appeals, 44 B.T.A. 865, redetermining deficiency in tax imposed against the Meridian & Thirteenth Realty Company by the Commissioner of Internal Revenue.

Reversed.

EVANS, CIRCUIT JUDGE. Whether a corporate distribution was a dividend or an interest payment, is the major issue on this appeal which involves Federal income taxes. The M. & T. Co., made an $1,800 payment in 1936, which it claims was interest on its indebtedness, but which the Commissioner asserts was a dividend on preferred stock. The Board of Tax Appeals concluded that the payment was one of interest on indebtedness, and therefore deductible Sec. 23(b) [7] of the Revenue Act of 1936, 26 U.S.C.A. Int.Rev. Acts, page 827, and held that the taxpayer had overpaid its income tax by $234. * * *

The facts are free from dispute—rather the problem is the construction of documents to ascertain the real intention of the parties as to the nature of the interest which the "preferred" stockholders held in the corporation.

The Company was organized in Indiana in 1922 for the purpose of erecting and owning a single building, a large building, in the City of Indianapolis. It entered into an underwriting agreement to finance the erection of the building, and, pursuant to the agreement, issued what was called "preferred" stock, of 4,250 shares of $100 par value each, and 2,000 shares of common stock.

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[6] Consider the rights of preferred stockholders to cumulative unpaid dividends on the dissolution of the corporation. See, Warren, The Progress of the Law: Corporations, 1921, 34 Harv.L.Rev. 282, 303; Developments in the Law—Corporations—1931, 1932, 45 Harv.L.Rev. 1374, 1376–1382; Notes, 1939, 52 Harv.L.Rev. 1331; 1931, 30 Mich.L.Rev. 281; 1929, 78 U. of Pa.L.Rev. 87; 1931, 40 Yale L.J. 828; 1931, 19 Calif. L.Rev. 450; 1930, 30 Col.L.Rev. 118; 1931, 31 Col.L.Rev. 163; 1931, 45 Harv.L.Rev. 185; 1932, 16 Minn.L.Rev. 313.

[7] "All interest paid or accrued within the taxable year on indebtedness" (shall be deductible).

The preferred stock had definite maturity dates. The Company, on December 31, 1936, retired $20,000 of the stock, and there then remained unretired, only $10,000.

Although the quere is simple, i. e., Is the relationship that of creditor or stockholder of a corporation? its determination may often be difficult because it is the result of adding and weighing several elements of a situation some of which may give rise to conflicting inferences. Precedents are abundant, but because of the widely-varying fact bases upon which the conclusions are reached, they serve only as guides. Many are the criteria[8] named to aid in the determination. Sometimes a particular one is called decisive,—or the most important test,—sometimes a combination of the elements sways the determination.

We cannot agree with the Board. Our conclusion is that the legal status here involved was that of a preferred stockholder, and not that of a creditor.

We feel impelled so to conclude, for numerous reasons, chief of which is that most of the attributes which are here claimed to be inherent in, and only compatible with, the creditor status, were here created in order to comply with, and follow, the Indiana statutes[9] relative to the issuance of preferred stock. They are therefore not at all indicative of intention of the parties to create a debtor-creditor relation. The intent of the parties in the establishment of the relation is of extreme importance, and where, as here, there is a simple explanation for the existence of provisions which might otherwise be associated with a creditor relationship, which explanation disproves that relationship, the ambiguous provisions lose most, if not all, of their weight.

We have cited the Indiana Statute solely to aid in the interpretation of the documents under consideration. We are fully cognizant of the holding of the Court in the case of United States v. Pelzer, 312 U.S. 399, 61 S.Ct. 659, 85 L.Ed. 913, where it was held that Federal tax laws are to be construed with a national uniform view point and not according to individual state constructions.

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[8] These criteria might be enumerated as follows:

Fixed maturity; payment of dividends out of earnings only; cumulative dividends; participation in management; whether unpaid dividends bear interest; right to sue in case of default, and whether status is equal to, or inferior to that of regular corporate creditors; nomenclature used in the documents; intent of the parties.

The Board carefully considered these criteria and stated:

"There are certain facts in this case which must be given due consideration but do not serve to determine the issue. These include, on the one hand, the use of the words 'preferred stock' and 'dividends,' the subordination of the rights of the preferred stockholders to those of general creditors, and, on the other hand, absence of voting rights in the preferred stock. Commissioner v. O. P. P. Holding Corporation, 2 Cir., 76 F.2d 11; Wiggin Terminals, Inc., v. United States, 1 Cir., 36 F.2d 893; Commissioner v. Proctor Shop, Inc., 9 Cir., 82 F.2d 792, affirming 30 B.T.A. 721. But this preferred had other and more significant characteristics. Each share had a fixed maturity date upon which it became payable; the common was held by nominees for the protection of the preferred; the holder of a share of preferred could enforce payment of the entire sum due as a debt in case of default; and the payment of the 6 percent was not dependent upon profits, but was payable and could be demanded in any event."

[9] Laws of Indiana, 1921, Chap. 35, Sec. 15.

We have no such extreme case as was presented in Arthur R. Jones Syndicate v. Commissioner, 23 F.2d 833, a case before this court, where there was obviously a misnomer of the parties' relationship in order to evade a usury statute. It was certain, there, that the parties called the obligation a preferred stock because they couldn't effect their illegal purpose otherwise. We believe the parties in the instant case intended the corporate certificate, by them termed "preferred stock," to be just that.

It is often said that the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event. But this variant in the relationship—while sharp in the case of a common stockholder and a bondholder—is less wide and distinct in the case of the preferred stockholder and the bondholder. The preferred stockholder has fortified his security with more safeguards than the common stockholder enjoys—and has deprived himself of some of the nebulous and speculative rights of the residuary claimant which the common stockholder enjoys. But, though the preferred stockholder's status is more secure, he has not quite achieved the protection which a creditor or bondholder enjoys, for he is subject to that very creditor's prior right to complete satisfaction of his obligation, in the distribution of the company's assets. In re 620 Church Street, 299 U.S. 24, 57 S.Ct. 88, 81 L.Ed. 16.

Important is the dispute between the parties over the preferred stockholder's asserted right, in the instant case, to payment of his dividend in any event or whether his right to dividends was restricted to earnings. This has a direct relation to the character of the right involved. A creditor has a right to be paid whether or not his debtor earns anything, but, under the Indiana statute quoted in the margin, a stockholder has no such absolute right to payment of dividends.

A reading of the statute and the above-quoted documents convinces us that the right to pay preferred stock dividends was limited to payment out of earnings. True, if dividends remain unpaid, and there be (a) a liquidation of the company, and (b) there be sufficient assets to meet regular creditors' obligations, then (c) the preferred stockholder is to receive his dividends from the assets before the common stockholders receive anything. That is but the usual right of a preferred stockholder. It is not support for a holding that preferred stock dividends are payable even though there be no earnings.

The Articles of Association provide that the preferred stockholder "shall be entitled to receive cumulative dividends * * before any dividend shall be paid on * * the common stock." Further, it says that "* * the Company shall, out of its earnings or through the proceeds of the sale of additional common stock, redeem its outstanding preferred stock * * plus all accumulated dividends. * *." The un-

derwriting agreement contains a similar provision—the preferment of the preferred stockholder over officers' salaries and common stockholders' dividends. It provides, to quote the exact language, that "so long as any of the preferred stock shall remain outstanding * * (the) company shall pay no salaries to its officers and no dividends on its common stock, except if there has been first set aside as surplus an amount equal to the preferred stock obligations for the next succeeding twelve months." A provision which withholds salaries or common stock dividends to protect preferred stockholders affords no support for a contention that preferred dividends are payable regardless of earnings.

Stockholders have no absolute right to dividends until they are declared. A creditor has a right to his interest in any event. The provision of the preferred stock certificate, which grants the holder thereof the right to require liquidation of the company for failure to comply with its obligations and agreements cannot be construed to give the right to require liquidation for failure to pay a quarterly dividend, but is limited to the company's failure to redeem preferred stock at maturity. It would not apply to the company's failure to pay quarterly dividends, if no earnings were available therefor. * * *

Great reliance is placed upon the fact that the stock had a definite maturity date, comparable to a creditor's obligation, which also has a definite date for payment. This factor may be considered, of course, but it is not conclusive. In some situations it yields readily to contrary inferences. Evidently the Board (see Pacific Southwest case, supra) itself does not consider this factor as an infallible indication of creditor relationship. Again we cite the fact that the Indiana statutes were cognizant of a maturity date as a normal feature of preferred stock and permitted its inclusion in preferred stock issues. It is reasonable to expect a company, which had bound itself to pay cumulatively a high rate of return on its preferred stock, and also provide for its retirement should protect itself by limiting such a heavy obligation to a specified period of time.

The element of statutory and contractual subordination of this preferred stock to rights of ordinary creditors, while not decisive, bears real weight, when coupled with the other facts above discussed. * * *

In passing upon the nature of this corporate obligation, we are considering an "ultimate finding" (Helvering, Commissioner, v. Tex-Penn Oil Co., 300 U.S. 481, 57 S.Ct. 569, 81 L.Ed. 755),—in effect, it is a conclusion of law. The question, whether a particular obligation is a debt or a stock interest within the meaning of the Revenue Act, must be determined in the light of all the facts. In the instant case the facts were all documentary. There was no oral testimony on this issue. Therefore, we believe it to be our duty to study all the documents and determine, in the light of the statute and precedent, whether the statutory

provision was meant to encompass the particular obligation under consideration. This is not a case where the finding of fact by the Board, supported by substantial evidence, precludes a review of such finding by this court. * * *

The decision is reversed.[10]

IN RE GREENEBAUM BROTHERS & COMPANY, INCORPORATED.

District Court of the United States, Pennsylvania, 1945. 62 F.Supp. 769.

Proceeding in the matter of Greenebaum Brothers & Company, Inc., bankrupt. On petition by the executrices of the estate of Simon Greenebaum to review the referee's final order of distribution of the bankrupt estate, and on petition of the bankrupt corporation for leave to intervene.

Exceptions to referee's order dismissed, petitions for review and intervention denied, and referee's order affirmed and confirmed.

KALODNER, DISTRICT JUDGE. Two petitions arising out of the Referee's final order of distribution of the bankrupt estate of Greenebaum Bros. & Co., Inc., have been presented for disposition. The one, a petition for review, was filed by the Executrices of the estate of Simon Greenebaum and asserts three alleged errors in the final order. The other is a petition of the bankrupt corporation filed by one of its attorneys, for leave to intervene.

The Trustee not only disputes the alleged substantive errors of the Referee, but denies the standing of the Executrices to question the Referee's order, and denies the right of the bankrupt to intervene at this time.

The executrices of the estate of Simon Greenebaum unquestionably stand in no better position than their decedent with regard to the right to petition this Court for review of the Referee's order. The right is asserted on the ground that Simon Greenebaum was the owner of all the outstanding stock in, and that he was the creditor of, the bankrupt corporation.

During his lifetime, Simon Greenebaum filed two proofs of claim against the bankrupt, one, for $65,000, was filed as a preferred stockholder's claim for the purpose of Chapter X, 11 U.S.C.A. § 501 et seq., proceedings; another, for $16,533.36, was based on the claim of a debt due in the amount of $15,000 because the bankrupt failed to call in 50 shares of preferred stock in each of the three years preceding the bankruptcy (1938, 1939 and 1940), plus $1,533.36, representing undeclared dividends.

Granting that Simon Greenebaum was a stockholder, and his estate now in his stead, no right to petition for review obtains thereby. The corporation having been adjudicated a bankrupt, the stockholders have

[10] This decision is inserted as a discussion of the nature of a preferred stock contract. Subsequently it has been held that the question whether an instrument is an evidence of debt or a preferred stock contract is a question of fact upon which the finding of The Tax Court is conclusive: The John Kelley Co. v. Commissioner, 326 U.S. 521, 66 S.Ct. 299 (1946).

no standing in the bankruptcy proceedings. [Citing cases.] * * *

Concerning the claims on which the creditorship is based, it should be noted that the Trustee filed objections thereto. Insofar as I can determine, the claims were never proved nor allowed. In his certificate the present Referee stated:

"* * * neither of which said claims were allowed by the said then Referee or by me as claims of a party in interest properly filed in this proceeding, entitled to a share in distribution out of the proceeds and funds realized by the Trustee in the liquidation of the bankrupt's assets. * * *"

A certificate of stock ownership, despite the fact that it contains a redemption clause, does not make the stockholder a creditor of the corporation. Warren v. Queen & Co., 1913, 240 Pa. 154, 158, 87 A. 595; Warren v. King, 1883, 108 U.S. 389, 399, 2 S.Ct. 789, 27 L.Ed. 769. And, as it will be seen, the obligation to redeem cannot be enforced after the corporation becomes insolvent. 14 C.J., Corporations, p. 424, § 585, 18 C.J.S., Corporations, § 278.

Moreover, the claims filed must disclose a debt due. In re A. & G. Knitting Mills, Inc., 3 Cir., 1944, 144 F.2d 125. On examination, the claims fail to meet this requirement. The stock certificate here involved provides that called stock be paid out of surplus or net profits, and the Pennsylvania Corporation Law forbids a corporation to redeem stock where such redemption would reduce the remaining assets below an amount sufficient to pay all debts and known liabilities: 15 P.S.Pa. § 2852—705. Also, the stockholder is not entitled to the corporate earnings until a dividend is declared. Green v. Philadelphia Inquirer Co., 1938, 329 Pa. 169, 175, 196 A. 32. Thus, if the claim were provable at all, it would have to disclose, at the very least, facts warranting the redemptions and dividends, aside from showing abuse of discretion by the directors. Wetherill v. Arasapha Manufacturing Co., 1915, 24 Pa. Dist. 1045, 1048; Green v. Philadelphia Inquirer Co., supra. Furthermore, it appears from the face of the stock certificate that it was issued in 1941, subsequent to the bankrupt's asserted failure to redeem (in 1938, 1939 and 1940).

Accordingly, I am of the opinion that the claims filed by Simon Greenebaum were neither proved nor allowed and the Executrices of his estate have no standing to petition this Court for review of the Referee's order. * * *

For the reasons stated the exceptions to the Referee's final order of distribution are dismissed, the petitions for review and intervention are denied and the Referee's Order is affirmed and confirmed.

2. CONVENTIONAL PREFERRED STOCK CONTRACT PROVISIONS

(a) Voting Rights.

GENERAL INV. CO. v. BETHLEHEM STEEL CORP.

Court of Chancery of New Jersey, 1917. 87 N.J.Eq. 234, 100 A. 347.

LANE, V. C. (orally at conclusion of argument on motion for temporary injunction).

This is an application for a temporary injunction to restrain Bethlehem Steel Corporation from increasing its capital stock. The present capital stock is $30,000,000 divided one-half preferred and the other common, with equal voting rights. The plan is to increase the capital stock by $45,000,000, the additional to be called common, class B. Of this, $30,000,000 is to be put out as a stock dividend; $15,000,000 is to be sold. The stock is to have all the characteristics of common, except that it will have no vote. The surplus of the company amounts to something like $69,000,000, and the scheme is proposed so as to get a part of this surplus out into the hands of stockholders and yet leave the money with the company as working capital. The intent of those who formulated the plan was to keep control of the company in its present stockholders. It is said that there is a good business reason for so doing. As part of the transaction, a contract was entered into by the company under which Seligman & Co., bankers, agreed to form a syndicate to underwrite the issue of $15,000,000 of the new stock. They were to be paid a certain commission, amounting in case the plan was unsuccessful, I think, to $225,000, and in case it was successful to $450,000. A portion of this commission was to be retained by Seligman & Co., and the remainder to be paid to those who should become syndicate subscribers. Among the syndicate subscribers were certain directors of the company, including Mr. Schwab. The plan was promulgated January 25, 1917, and immediately became public. The bill is brought by the General Investment Company, a corporation dominated and controlled by Clarence H. Venner. He bought his stock, 100 shares, January 31, 1917, and immediately notified the company of opposition to the plan. He filed his bill on February 9th. The meeting of stockholders called for the purpose of acting on the increase was scheduled to be held February 14th. The last day for stockholders to subscribe under the syndicate agreement is March 8th. The contract between the company and the bankers provided for a limited time of performance. It is represented, and the court will take judicial notice of the fact, that, in the present unsettled condition of affairs, contracts of this nature dealing with the sums here dealt with must be entered into with a very limited time provided for performance; nothing else is conceivable.

On the day fixed the meeting was held. There were voted in favor of the plan 126,370 shares of preferred and 112,156 shares of common stock, and against the plan 450 shares of preferred and 125 shares of common stock, of which latter 100 shares were those held by the complainant.

There is another common stockholder holding 25 shares who after argument by complainant's counsel to-day seeks to intervene. In view of my conclusions I shall deny her application. The situation therefore is that over 99 per cent. of the present stock desire that the plan should go forward, and opposition is made by only 125 shares. Of these, 100 were actually bought after the promulgation of the plan, and I think for the sole purpose of bringing this suit, notwithstanding the denial of Mr. Venner. The law is settled that even under these circumstances this court must consider any equitable or legal right which the complainant may have cognizable or enforceable only in a court of equity. Hodge v. United States Steel Corporation, 64 N.J.Eq. 111, 53 A. 553. The reason of the rule I assume is, as applied to stock, that to hold otherwise would be to impose a restraint upon alienation. A holder of stock before the threatened act must be able to transfer all of his rights to any one or the value of the stock may be affected. Notwithstanding this rule, before this court will intervene, at the suit of a stockholder who buys in under the conditions present here, a very small amount of stock, to prevent the carrying out of a plan such as this, approved by practically the entire stock issued, it must be satisfied that the right of the complainant is clear and the injury irreparable. Vice Chancellor Pitney, in Trimble v. American Sugar Refining Company, 61 N.J.Eq. 340, at 345, 48 A. 912. The attack made upon the plan I will consider, putting out of mind, as far as I can, the circumstances under which it comes here.

Complainant asserts: Firstly, that the corporation has no power to issue a class of common stock, or a class of stock having all the characteristics of common stock, without the voting privilege; secondly, that because it is admitted that the purpose is to perpetuate the present control of the corporation, and because some of the directors who voted in favor of it became syndicate subscribers, and therefore will profit by its success, the entire proceedings are vitiated and void.

1. Whether the corporation has the legal power to issue this class of stock depends upon the construction to be put upon the eighteenth section of the Corporation Act. Revision of 1896; Comp.Stat., p. 1608.[11] From a casual reading of that section it would seem that stock of any kind, nature, or description, common or preferred, or whatever it may be called, may be created with or without voting privileges. Counsel for complainant insists that the section must be construed in the light of a public policy said to have prevailed at the time the section was adopted and to prevail now, i.e., that common stockholders at least are entitled to consultation with, and advice of, and action by every other common stockholder, and that the policy of the law required that a corporation should be managed by a majority of its stock. In other words, the privilege of voting is necessarily incidental to common stock. The cases relied on are Cone v. Russell & Mason, 48 N.J.Eq. 208, 21 A. 847; White v. Thomas Inflatable Tire Company, 52 N.J.Eq. 178, 28 A. 75. But see Chapman v. Bates, 61 N.J.Eq. 658, at page 667, 47 A. 638, 88 Am.St.Rep. 459.

[11] N.J.Comp.Stat., Rev.1896, p. 1608, § 18, N.J.S.A. 14:8-1, appears, infra, p. 521.

The question is not, however, whether, after a person has purchased stock in a corporation having a certain amount of stock vested with the right to vote, these fellow stockholders may voluntarily separate the right of property from the right to vote, and thus put the control of the corporation in the hands of those having no pecuniary interest therein and deprive the dissenting stockholder of the advice and action of those whose advice and action he may have fairly be said to have contracted for, but rather whether such stockholder is entitled to require that any new stock issued should be vested with the privilege of voting—a very different proposition. I have examined in the short time I have had all the cases that I could locate, and I have failed to find any statement of such public policy, with possibly the exception of a remark made by Judge Lurton in Hamlin v. Toledo, St. L. R. R., 78 F. 671, 24 C.C.A. 271, 278, 36 L.R.A. 826, in which, while sustaining an issue of preferred stock, or rather, an issue of stock which was neither preferred nor common, a rather peculiar kind of stock, as he called it, he said:

"They surrendered the privilege of voting. That was perhaps a valid agreement between stockholders, though of doubtful public policy."

It is almost impossible to get a definition of "common stock" or a statement of what classes of stock may be issued, and the necessary rights and privileges of the classes, that is satisfactory. Thompson, § 3426, in referring to common stock, says that the name itself indicates its nature, and it is so called because it is the common stock, or the stock which private corporations generally issue; and is usually the only kind authorized. He says the universal rule is that the owners of common stock are entitled to a pro rata dividend of profits, and to a pro rata participation in the management of the corporation; that the holders of common stock sometimes have a preference in the management of the corporation. In section 3425 with reference to classes of stock he states:

"The first general division of stock is into common or preferred stock; and these two classes are again subdivided into almost an infinite variety."

Section 859: "The rule that a right to vote follows the ownership of stock means only that in the absence of any common restriction upon all the stock, or upon a class of stock, this right prevails. That is, the right of a stockholder to vote cannot be arbitrarily abridged and is not subject to universal restriction. But the rule is equally emphatic, if not so general, that restrictions may be placed upon the right to vote; or, as sometimes stated, the right to vote may be separated from the ownership of stock. It must be remembered, in this connection, that stockholders can make any agreement respecting their stock, or the voting of it, that they may see fit or deem wise, except agreements that are void as against public policy."

He cites Miller v. Ratterman, 47 Ohio St. 141, 24 N.E. 496, Supreme Court of Ohio. There the question was as to whether preferred stock might be issued without voting privileges. The court said:

"It is true that one characteristic of stock, generally, is that it can be voted upon. But this is not essential. Indeed, instances may arise where it is good policy to prohibit the voting upon stock"—citing cases.

Thompson, § 859, contains the statement:

"So, it has been established that holders of preferred stock may be denied the right to vote the same at any meeting of the holders of the capital stock of the corporation. The legality of such restriction is not based on the theory that preferred stockholders are guaranteed a dividend, but rather on the inherent power of the corporation to restrict the voting power. It is simply a contract relation between two classes of stockholders, in which the public has no concern."

He instances a great number of cases where restrictions with respect to voting has been imposed upon common stock; i. e., one stockholder should not vote more than a fourth of the total, a stockholder should not vote more than 100 shares, nonresidents should not vote, purchasers of forfeited stock should not vote, even though not liable for the amount due until the amount due was paid.

"There is no rule of public policy which forbids a corporation and its stockholders from making any contract they please in regard to restrictions on the voting power." Cook on Corporations, § 622B.

"Inasmuch as preferred stockholders are members of the company, and except in so far as their rights may be altered by the contract, statute or by-law under which the shares are issued, entitled in all respects to the same rights as other shareholders, it follows that they have the same voting rights as other shareholders. The right of shareholders to vote is, however, like the right to dividends or to participate equally in a division of capital on liquidation, regarded as a private matter for each shareholder which he may waive if he choose. Consequently, a provision that shareholders of a certain class shall have no right to vote is, if assented to by them, quite valid. Such a provision might theoretically be made as to either the preferred or the deferred (Machen calls common deferred shares), but it is much more common with respect to the preferred shares so as to compensate the other shareholders for the preference of the preferred stockholders as to dividends." Machen, § 570.

"A stockholder has no right to vote at corporate meetings, whether the stock is common or preferred, if it is so stipulated when the stock is issued, for the stipulation is then a term of his contract." 3 Clark & Marshall, p. 1996.[12]

Mackintosh et al. v. Flint P. M. R. Co., C.C., 32 F. 350, and Id., 34 F. 582, is referred to in Clark & Marshall as authority for the proposition

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[12] N.Y.Stock Corporation Law, § 51: "*Limitations on right to vote.*—The certificate of incorporation * * * may provide * * * that the holders of any designated class or classes of stock shall not be entitled to vote or it may otherwise limit or define the respective voting powers of the several classes of stock * * * But unless specifically excluded * * from the right to vote in a proceeding for mortgaging the property and franchises of the corporation * *, for guaranteeing the bonds of another corporation * * *, for sale of the franchises and property * * *, for establishing priorities or creating preferences among the several classes of stock * * *, for consolidation * * *, or for change of name * * *, all shares of stock shall be entitled to vote in every such proceeding."

that preferred stock may be given the exclusive privilege of voting, at least in that case for a time. Counsel have not referred me to any case enunciating a public policy which would require that all common stockholders should have the voting privilege. In this state it has been held that the matter is purely one of contract. McGregor v. Home Ins. Company of N.J., 33 N.J.Eq. 181; In re Newark Library Ass'n, 64 N.J.L. 218, 43 A. 435. This seems to be the rule in the other states.

Section 13 of the Delaware Corporation Act (Laws 1901–03, p. 291, c. 167) is or was precisely similar to our section 18. The construction of that statute came before the Supreme Court of Delaware in State v. Brooks, Del., 74 A. 37. Preferred stock had been issued without the right to vote. There was a constitutional provision providing that all stock issued should have voting privileges. It was contended that the issuance of the preferred stock was in violation of this provision. The court held not, and that the Constitution meant that stock should vote which by law had a vote; that there was no public policy which prevented the issuance of stock without the voting privilege. The reasoning of the court is as applicable to common as to preferred stock assuming that the relation between the stockholders is purely one of contract. The case was reversed in the Court of Appeals, 3 Boyce 1, 26 Del. 1, 79 A. 790, 51 L.R.A.,N.S., 1126, Ann.Cas. 1915A, 1133, but upon the ground that the constitutional provision meant what it said, and that the statute was in violation of the provision. The constitutional provision had been repealed before the decision, and the court points out that there is a distinction between the situation in New Jersey, and in Delaware, i. e., the absence in New Jersey of any such constitutional provision. Turning to the statute:

"Every corporation organized under this act shall have power to create two or more kinds of stock, of such classes, with such designations, preferences and voting powers or restrictions or qualifications thereof as shall be stated and expressed in the certificate of incorporation or in any certificate of amendment thereof." [13]

No broader language could have been used, and, unless the usual meaning of these words is to be restricted by reason of the existence of some public policy, it is inconceivable to me that a corporation may not issue this class of common stock, or call it what you will. I have failed to find the existence of any such public policy. The matter is one for the stockholders to determine by their contract. If the public does not want to buy, it does not have to. The legal rights of the present stockholders are not affected; they contracted at the time they went in that they would have the advice, consultation with, and action by (or rather the opportunity of securing such advice, consultation, and action) of the then existing stock (and this subject to its reduction

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13 Cf. N.J.S.A. § 14:8–1: "Every corporation organized under this title may create two or more classes of stock, any of which may be stock with par value or stock without nominal or par value, with full, limited or no voting powers, of such classes, with such designations, preferences, relative, participating, optional or other special rights, qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation, but no stock with par value shall be created entitling the holders thereof to receive preferred dividends thereon in excess of eight per cent per annum. * * *"

Cf. N.Y.Stock Corporation Law, § 11.

in accordance with law); but there was no contract that the corporation would, if it created further stock, give that further stock the voting privilege, so that the present stockholders might have the opportunity of securing advice by and consultation with and action by the new stockholders. I think that the reasoning of the cases of which Cone v. Russell & Mason, supra, is one, does not apply in the case of an issue of a new class of stock. Section 18 has received the consideration of the Court of Errors and Appeals in Lloyd v. Pennsylvania Electric Vehicle Co., 75 N.J.Eq. 263, 72 A. 16, 21 L.R.A.,N.S., 228, 138 Am.St. Rep. 557, 20 Ann.Cas. 119; Mr. Justice Swayze delivering the opinion of the court. * * *

If a corporation may issue what are commonly called "founders' shares," I can hardly see how it can be said that it cannot issue a class of stock called common, class B, without voting power. As I presently view it, this new stock is common. I do not agree with Mr. Hardin that the effect of this plan is to make the present common a class of preferred stock. I think that it is one of the subdivisions of the common. The essential elements of common stock are that the holders have an opportunity to make profit if there is any and participate in the assets after all other claims are paid, and bear the loss if there be such.

"By common stock is meant that stock which entitled the owners of it to an equal pro rata division of profits, if any there be; one stockholder or class of stockholders having no advantage, priority, or preference over any other shareholder or class of stockholders in the division." Cook, § 12, p. 62.

I think he refers to material advantages, priorities, and preferences, and not to such privilege as the right to vote. See, also, Elkins v. Camden Atl. R. Co., 36 N.J.Eq. 233, at page 237. When there is found stock which answers so far as material interest in the property is concerned these conditions, this is the common stock. The Legislature has provided that this common stock may be divided into any number of classes. The only distinction which I can think of must be in relation to voting rights. There may be class A voting stock with full voting power, class B, allowing each share one-half a vote, and so on.

The bar generally, I think, has put the construction that I have put on this section. There were introduced in evidence some 15 or more charters, some of very large corporations, providing for classes of common stock with and without voting power and one or more with the preferred stock having the exclusive voting power. The conclusion I have reached is that the corporation may issue this peculiar class of stock.

2. A. That the purpose of the plan is to retain control in the present stockholders does not vitiate it. The question is one of good faith. There is no charge of bad faith in the present case. In Warren v. Pim, 66 N.J.Eq. 353, page 408, 59 A. 773, 794, Mr. Justice Swayze, dissenting, said (referring to the voting trust):

"If the only object of the voting trust is to secure permanency of management, with a view to what the stockholder honestly considers

to be the best interest of the corporation, I see no objection to the adoption of any necessary means authorized by the statute to secure that end. * * * But can it be contended that, if a corporation finds it necessary to borrow money upon bonds issued for a long term of years, the stockholders cannot, consistently with public policy, in order to secure the loan, vest the management of the corporation in hands satisfactory to the lenders and for a term commensurate with the loan?"

The opinion, though a dissenting one, secured the vote of five other judges. The case was decided by a vote of seven to six upon another point. Only two judges took a diametrically opposite view. The opinion, therefore, is entitled to great weight.

There are many cases in other states not necessary to cite holding that it is within the power of stockholders to combine for the purpose of maintaining a management in control, and if done in good faith there is no legal objection to it. The mere fact that one of the results of the plan may be to perpetuate the control in the hands of its present stockholders does not vitiate the plan. The stockholders were entitled to vote as their selfish interests dictated. * * *[14]

The order to show cause will be discharged, and the restraint vacated.[15]

ELLINGWOOD v. WOLF'S HEAD OIL REFINING COMPANY, INCORPORATED, et al.

Supreme Court, Delaware, 1944. 38 A.2d 743.

Appeal from Court of Chancery.

Proceeding under Revised Code 1935, § 2063, by Charles H. Ellingwood against Wolf's Head Oil Refining Company, Incorporated, and others, to determine the validity of election of directors of the corporation. From an adverse decree, 33 A.2d 409, the complainant appeals.

Affirmed.

In the Supreme Court of the State of Delaware, No. 1 November Term, 1943 session. Appeal from a decision of the Court of Chancery reviewing the corporate election of directors of Wolf's Head Oil Refining Company, Incorporated, held on May 3, 1943, under Section 31 of the General Corporation Law, Rev.Code 1935, § 2063.

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14 Cf. Gamble v. Queens County Water Co., 123 N.Y. 91, 25 N.E. 201, 9 L.R.A. 527. N.Y.Stock Corporation Law, § 50, permits voting trusts for a period not exceeding ten years; but a voting trust agreement is prohibited among stockholders of a banking corporation. See, also, N.J.S.A. 14:10–10. On voting trusts in general see, Baldwin, Voting Trusts, 1891, 1 Yale L.J. 1; Bergerman, Voting Trusts and Non-Voting Stock, 1928, 37 Yale L.J. 445; Burke, Voting Trusts Currently Observed, 1940, 24 Minn.L.Rev. 347; Finkelstein, Voting Trust Agreements 1926, 24 Mich.L.Rev. 344; Meck, Employment of Corporate Executives by Majority Stockholders, 1938, 47 Yale L.J. 1079; Smith, Limitations on the Validity of Voting Trusts, 1922, 22 Col.L.Rev. 627; Wormser, The Legality of Corporate Voting Trusts and Pooling Agreements, 1918, 18 Col.L.Rev. 123; Legis., 1926, 26 Col.L.Rev. 97; Note, 1925, 25 Col.L.Rev. 951; 1938, 38 Col.L.Rev. 508.

15 See, infra, p. 593, where plaintiff again attempted to have a proposed increase of capital stock restrained.

This case was originally brought in the Court of Chancery by the complainant below, appellant, in his capacity as a common stockholder of Wolf's Head Oil Refining Company, Incorporated, which was originally incorporated in this State in October, 1929, under the corporate name of Wolverine-Empire Refining Co. The present name having been acquired by an amendment to its charter in November 1940.

The charter provided for both preferred and common stock. The authorized number of shares of preferred stock being 50,000, of which 46,100 are outstanding, and the authorized number of shares of common stock being 30,000 all of which are outstanding.

The right of the corporation to redeem the preferred stock, and the respective rights of both the preferred and common stock in the event of any liquidation, dissolution of or wind up of the affairs of the corporation are set forth in Article 4 of the Certificate of Incorporation. Likewise the dividend and voting rights of both the preferred and common stock are set forth in Article 5 of the Certificate of Incorporation. * * *

Article 5. "The holders of preferred stock shall be entitled to cumulative dividends thereon at the rate of six per cent for each and every fiscal year of the company, and no more, payable out of any and all surplus or net profits quarterly, half-yearly or yearly, when and as declared by the Board of Directors. Such dividends on the preferred stock shall be payable in any fiscal year before any dividends shall be paid or set aside for the common stock in that year, and the preferred stock shall not be entitled to participation in any other or additional profits. Out of any surplus or net profits of the corporation remaining after the full dividend of six per cent. on the preferred stock then outstanding shall have been declared and paid, or provided for in any year, dividends may be declared on the common stock for such year; except that no dividend on the common stock shall be declared or paid out of any surplus acquired or created by the purchase or acquisition of the stock or assets of the Empire Oil Works, a corporation of Pennsylvania, and/or, of the Wolverine Lubricants Co., Inc., a corporation of New York.

"Except as otherwise required by the statutes of the State of Delaware, or as herein otherwise provided, the holders of the common stock shall exclusively possess voting power for the election of directors, and for all other purposes, and the holders of the preferred stock shall have no voting power; provided however, that if at any time the corporation shall be in default in respect to the declaration and payment of dividends in the amount of two years' dividends on the preferred stock, then the holders of a majority of the preferred stock shall have an election to exercise the sole right to vote for the election of directors and for all other purposes, to the exclusion of any such right on the part of the holders of the common stock until the corporation shall have declared and paid for a period of a full year a 6% dividend on the preferred stock, when the right to vote for the election of directors, and for all other purposes, shall revert to the holders of the common stock. The election on the part of the holders of

the preferred stock shall be consummated and effectuated by a notice to the corporation of their decision to exercise such right by holders of a majority of the preferred stock. During the time within which the holders of the preferred stock are exercising under this election the right to vote upon their stock, the holders of the common stock shall have no right to vote upon their stock. The said right of the preferred stock and its holders to exercise an election to vote shall survive any exercise of such election and a subsequent reversion of the right to vote to the common stock and its holders, and shall be a continuing privilege and right of said preferred stock; and the subsequent right to a reversion of the voting power to the common stock in the event of the payment of a full year's 6% dividend shall be a continuing privilege and right of said common stock and its holders".

The By-Laws of said corporation fix its fiscal year as the calendar year, and further provide that it shall be managed by a Board of Directors consisting of seven who are to be elected at the annual meeting of the stockholders to be held on the first Monday of May of each year, and to serve for one year or until their successors shall be elected and qualified.

The bill discloses that at the closing of the year 1934, the respondent corporation, the appellee, had defaulted in the declaration and payment of dividends in the amount of two years' dividends, on its outstanding preferred stock; but that regardless of said default, the preferred stockholders of said corporation did not elect to exercise the sole right to vote for the election of directors at the annual stockholders meeting on May 6, 1935. But at the annual meeting of the stockholders held on May 4, 1936, said holders of the preferred stock of the corporation did assume to exercise the sole voting rights claimed by them under the above-quoted provisions of Section 5 of the Certificate of Incorporation and continued to exercise such voting rights down to and including the year 1942.

From the time of the organization of the said corporation in 1929, various arrearages of dividends accrued on the preferred stock. When a majority of the preferred stockholders finally decided to exercise their sole right to vote for the election of directors and for all other purposes, by giving a notice to the corporation of their decision to exercise such right, dividends had accrued on the preferred stock in the amount of 37½% of the par value. Dividends paid on the preferred stock during the same period, however, amounted to 15% of the par value, leaving accrued and unpaid dividends on said preferred stock in May 1936, when said preferred stockholders first gave notice to the corporation of their election to exercise the sole right to vote for the election of directors and for all other purposes, amounting to 22½% of the par value.

After the preferred stockholders acquired the sole right to vote for the election of directors and for all other purposes in May 1936, they continued to exercise that right until May 1943, at which time the common stockholders claimed that the sole right to vote for the election of directors and for all other purposes had reverted to them under the provisions of Article 5 of the Certificate of Incorporation

above set forth. In support of this contention they relied upon the fact that during the year 1942, and for the period of a full year prior to May 3, 1943, a six per cent dividend had been paid on the preferred stock.

In April 1943, the holders of a majority of the preferred stock again gave notice to the corporation of their election to exercise the sole right to vote for the election of directors and for all other purposes, giving as their reason therefor, that the corporation was in default in regard to the declaration and payment of dividends in the amount of two years' dividends on the preferred stock. Consequently at the annual meeting on May 3, 1943, a majority of the preferred stockholders claiming their right to vote for the election of directors and for all other purposes, elected a board of seven directors. Likewise certain common stockholders, including the appellant, claiming their right to vote for the election of directors and for all other purposes, at said annual meeting on May 3, 1943, elected a board of seven directors. The appellant instituted this proceeding before the Chancellor to determine which of said elections was valid and who constituted the Board of Directors of the corporation.

The Chancellor held that the preferred stockholders were entitled to vote for the election of directors and for all other purposes at the annual meeting held on May 3, 1943, and that the persons whose names were contained on the ticket for which they voted were the legally elected directors of the corporation.

This appeal was taken to review this decision and four assignments of error were filed. These assignments of error are all embraced in the first which is as follows: "That the Chancellor erred in declaring that the persons owning the preferred stock of Wolf's Head Oil Refining Company, Incorporated, had the sole right and power to vote at the meeting of stockholders of the corporation on May 3, 1943, for the election of directors and for all other purposes".

RICHARDS, JUDGE. There is no dispute between the parties interested in this proceeding, that when the preferred stockholders and the common stockholders met at the annual meeting held on May 3, 1943, the corporation was in default in respect to the declaration and payment of dividends in the amount of two year's dividends on the preferred stock. All of said arrearages of dividends having accrued prior to 1942, and that during said year 1942 the corporation declared and paid a full six percent dividend on the preferred stock.

This being the situation the Court is called upon to determine the voting rights of the two classes of stock under the pertinent charter provisions.

It is well recognized that a certificate of incorporation may contain any provision with respect to the stock to be issued by the corporation, and the voting rights to be exercised by said stock, that is agreed upon by the stockholders, provided that the provision agreed to is not against public policy. Thompson on Corporations, 3d Ed., Sec. 989.

The Courts of this State have held that the rights of stockholders are contract rights and that it is necessary to look to the certificate

of incorporation to ascertain what those rights are. Gaskill v. Gladys Belle Oil Co., 16 Del.Ch. 289, 298, 146 A. 337; Penington v. Commonwealth Const. Hotel Corp., 17 Del.Ch. 188, 151 A. 228; Id., 17 Del. Ch. 394, 155 A. 514, 75 A.L.R. 1136.

Nothing is to be presumed in favor of preferences attached to stock, and when a corporate charter attempts to confer preferences upon any class of stock provided for by it the same should be expressed in clear language. In interpreting the meaning of charter provisions the same method is applied as that which is followed in interpreting written contracts generally. The instrument should be considered in its entirety, and all of the language reviewed together in order to determine the meaning intended to be given to any portion of it. Holland v. National Automotive Fibres, Inc., 22 Del.Ch. 99, 194 A. 124; Gaskill v. Gladys Belle Oil Co., supra; Penington v. Commonwealth Hotel Construction Co., supra.

The charter of Wolf's Head Oil Refining Company, Incorporated, evidences an intention on the part of the incorporators to make provision for the protection of the preferred stockholders.

It is specified in article four of the charter, that in case of "liquidation, dissolution or winding up of the affairs of the corporation", said preferred stockholders shall be entitled to full payment of the par value of their shares and all unpaid dividends accrued thereon, before any of the assets shall be distributed to the common stockholders. This same article gives to the Board of Directors the optional right to redeem the preferred stock in whole or in part, at any time before January first, 1940, but requires said Board of Directors to give sixty days' notice to all record holders of said preferred stock; and in addition thereto to pay in cash to each holder of preferred stock to be redeemed one hundred and ten percent of the par value thereof.

Now we come to article five of the charter which guarantees to the holders of the preferred stock "cumulative dividends thereon at the rate of six percent for each and every fiscal year of the company". This same article gives to the holders of the common stock exclusive "voting power for the election of directors, and for all other purposes". This is followed by the provision that the preferred stockholders shall have no voting power. Then comes the proviso, "that if at any time the corporation shall be in default in respect to the declaration and payment of dividends in the amount of two years dividends on the preferred stock, then the holders of a majority of the preferred shall have an election to exercise the sole right to vote for the election of directors and for all other purposes, to the exclusion of any such right on the part of the holders of the common stock until the corporation shall have declared and paid for a period of a full year a 6% dividend on the preferred stock, when the right to vote for the election of directors, and for all other purposes, shall revert to the holders of the common stock". We desire to emphasize the fact that the wording of the above-quoted article is, "if at any time the corporation shall be in default in respect to the declaration and payment of dividends in the amount of two years' dividends on the preferred stock".

The appellant contends that the subsequent wording of the article, "until the corporation shall have declared and paid for a period of a full year a 6% dividend on the preferred stock", restricts the above-quoted language of the article with respect to the duration of the time when the preferred stockholders have the right to elect to exercise the sole right to vote for the election of directors and for all other purposes. If this be true, it likewise takes from the preferred stockholders a portion of the protection which we have pointed out was conferred upon them by the charter.

The appellant takes the position that after the preferred stockholders have elected to exercise the sole right to vote for the election of directors and for all other purposes, and have actually exercised said right to vote in pursuance of the election to do so, the payment of a six percent dividend for the period of a full year causes said sole right to vote by the preferred stockholders, to revert to the common stockholders until the corporation shall again default in respect to the declaration and payment of dividends in the amount of two years' dividends on the preferred stock. This ignores the rights of the preferred stockholders if the corporation is still in default in the payment of dividends on said preferred stock in the amount of two years' dividends. This also loses sight of the fact that the plain words of the charter are, "if at any time the corporation shall be in default"; and the further plain provision that "the said right of the preferred stock and its holders to exercise an election to vote shall survive any exercise of such election and a subsequent reversion of the right to vote to the common stock and its holders, and shall be a continuing privilege and right of said preferred stockholders". We agree that when a six percent dividend for a period of a full year is paid on the preferred stock, the sole right to vote for directors and for all other purposes reverts to the common stockholders, notwithstanding the fact that dividends in the amount of two years are due on the preferred stock. If the preferred stockholders failed to again elect to exercise the sole right to vote, by giving notice to the corporation of their decision to exercise such right, as the charter requires them to do, the common stockholders would be entitled to exercise the right to vote for the election of directors and for all other purposes. But if the corporation is still in default in the declaration and payment of dividends in the amount of two years' dividends on the preferred stock, when a six percent dividend is paid on preferred stock for the period of a full year, said preferred stockholders can still avail themselves of the right to vote for the election of directors and for all other purposes, if they comply with the conditions of the charter by giving notice to the corporation of their decision to exercise such right to vote.

The language used in the charter describing the conditions under which the preferred stockholders obtain the right to vote has nothing to say about the time when the arrearage in dividends on said stock shall have accrued. If the position is taken that the arrearage in dividends must have accrued after the right to vote had reverted to the common stock, the preferred stockholders would be deprived of the right to vote for the election of directors no matter how great the

arrearage in dividends might be, until additional dividends in the amount of two years' dividends should accrue. This construction would take from the preferred stockholders the benefit which we think the charter intended to confer upon them.

It is not denied that when a majority of the preferred stockholders first elected to exercise their right to vote for the election of directors and for all other purposes in 1936, the dividends accrued and unpaid on the preferred stock amounted to 22½%, of that said accrued and unpaid dividends was more than two years dividends.

Neither is it denied that from 1936 to May 3, 1943, additional dividends accrued on the preferred stock amounting to 40½%, and that the dividends paid on said stock during that period amounted to 25½%.

Therefore it clearly appears that when the annual meeting of the corporation was held on May 3, 1943, dividends amounting to 37½% were accrued and unpaid on the preferred stock. Thus it appears that the corporation was in default in respect to the declaration and payment of dividends in the amount of two years' dividends.

In view of this situation we are of the opinion that the preferred stockholders were entitled to vote for the election of directors and for all other purposes, at the annual meeting of the corporation held on May 3, 1943, and that the persons whose names appeared on the ticket nominated and voted for by them are the legally elected directors of the corporation.

The decree of the Chancellor is affirmed.

* * *

(b) *Cumulative Dividends*

PREFERRED STOCK CLAUSES

CUMULATIVE DIVIDENDS. (PAR VALUE)

The holders of the preferred stock shall be entitled to receive, when and as declared by the board of directors of the corporation, out of any assets of the corporation available for dividends pursuant to the laws of the State of ———, preferential dividends at the rate of ——— per centum (———%) per annum and no more, payable annually, semi-annually or quarterly on

(1) such days as may be determined by the board of directors

(2) the first days of ——— and ——— in each year

before any dividend shall be declared or paid upon or set apart for the common stock. Such dividends upon the preferred stock shall be cumulative from {the date of issue thereof ———, / the first day of ——— 19———,} so that if dividends for any past dividend period at the rate of ——— per centum (———%) per annum shall not have been paid thereon, or declared and a sum sufficient for payment thereof set apart, the deficiency shall be fully paid or set apart but without interest, before any dividend shall be paid upon or set apart for the common stock. When-

ever the full dividend upon the preferred stock for all past dividend periods shall have been paid, and the full dividend thereon for the then current dividend period shall have been paid or declared and a sum sufficient for the payment thereof set apart, dividends upon the common stock may be declared by the board of directors out of the remainder of the assets available therefor.

BOARDMAN v. THE LAKE SHORE & MICHIGAN SOUTHERN RAILWAY CO.

Court of Appeals of New York, 1881. 84 N.Y. 157.

Appeal from a judgment of General Term of the Supreme Court, First Department, entered on an order affirming a judgment for plaintiffs, entered on a decision of the court on trial at Special Term.

[The Michigan Southern & Northern Indiana Co., in 1857, issued $3,000,000 of preferred stock. The certificate provided that "the stock is entitled to dividends at the rate of 10% per annum, payable semi-annually * * * out of the net earnings of said company; and is also entitled to share *pro rata* with the other stock of the company in any excess of earnings over 10% per annum, and the payment of dividends * * * is hereby guaranteed * * *"

In 1862, 23 shares of this preferred stock were assigned to plaintiff's testator.

From 1857 to August 1863, no dividends were declared because the company failed to realize any net earnings. From August 1, 1863 to 1869 a 10% annual dividend was regularly paid.

In 1864 and 1865, out of accumulated surplus, two 3½% dividends on the common stock were paid. These dividends amounted to a sum sufficient to have cancelled and paid off all arrearages on the outstanding preferred stock.

In 1869, the company merged with the Lake Shore Railway Company, the consolidated company being defendant herein. The new company assumed and agreed to pay all existing debts, guarantees and obligations of the merged corporation.

This action was brought in 1875 to compel defendant to pay the 10% annual dividends unpaid by the Michigan Southern & Northern Indiana Co. from 1857–1863 on the shares of stock owned by plaintiff's testator; and to enjoin defendant from declaring dividends on certain common stock until the amount so claimed shall have been paid.

Defendant appeals from a judgment for plaintiff.]

MILLER, J. * * * The doctrine that preference shareholders are entitled to be first paid the amount of dividends guaranteed, and of all arrears of dividend or interest before the other shareholders are entitled to receive anything, and although they can receive no profits where none are earned, yet as soon as there are any profits to divide they are entitled to the same, is fully supported by authority. In Henry v. G. N. R. R. Co., 3 Jurist, N.S., part 1, 1117, affirmed upon appeal, reported in 3 Jurist, 1133, the right of preference rather than that of guaranteed stockholders to dividends in arrears was involved,

and it was held by the Vice-Chancellor that the company had no right to declare a dividend so as to affect the right of preference stockholders, and that they were entitled to their full dividend for the period which had elapsed since the last payment of dividend, before the ordinary stockholder can take any dividend whatever. Upon appeal the decision was affirmed, and it was held that preference shareholders had a right to dividends at the stipulated rate chargeable exclusively as profits, and payable before anything is divided among the common shareholders. The Lord Chancellor, Cranworth, says: "That if, on the declaration of a dividend, the fund to be divided should be insufficient to satisfy the claims of the shareholders entitled to preference, those shareholders will be entitled to be paid in full out of all subsequent dividends before the ordinary shareholders can receive any thing." In the case last cited there were four classes of preferred stock, and the same principle is involved as arises in the case at bar. In Crawford v. N. E. R. R. Co., 3 Jurist, N.S., part 1, 1093, preference dividends were held to be a charge upon the profits of the company for all time, to the extent of the preference dividend held out as payable on the preference shares. The condition here was, that the preference shares should be entitled to a certain rate per annum for the periods named, and in part in perpetuity thereafter on the amount actually paid in. It was said that the words "interest" and "dividends" should be treated as synonymous. See, also, Sturge v. E. N. R. R. Co., 31 Eng. L. & Eq. 406, which decides that the holders of preference shares are entitled to be paid the amount of arrears out of any money belonging to the company applicable to such payment, before any payment shall be made by the company, to the ordinary shareholders in respect to dividends or interest. It is claimed that in the last two cases it was held that the preference dividends were a charge, because the contract was not for the payment of dividends at fixed times, but because the dividends were payable out of the revenues of the company at any time; but we think that those decisions were not made upon any such ground, but upon the principle that preference dividends must be paid before any others, which is well established and supported by the cases cited, as well as numerous other authorities. * * *

STROUT v. CROSS, AUSTIN & IRELAND LUMBER CO.

Court of Appeals of New York, 1940. 283 N.Y. 406, 28 N.E.2d 890.

Action by Waneta W. Strout against Cross, Austin & Ireland Lumber Company to secure equitable relief against use of income notes as part payment of unpaid accumulated dividends on first preferred stock. From a judgment entered upon an order of the Appellate Division, First Department, 258 App.Div. 1046, 18 N.Y.S.2d 996, unanimously affirming a judgment of the Supreme Court, New York County, entered September 14, 1939, dismissing the complaint upon the merits, plaintiff appeals by permission of the Court of Appeals, after

motion for leave to appeal had been denied by the Appellate Division in 259 App.Div. 714, 19 N.Y.S.2d 769.

Reversed and remanded with directions.

LEWIS, JUDGE. The plaintiff is the owner of a substantial portion of the cumulative preferred stock issued by the defendant upon which in 1937, there were unpaid accumulated dividends amounting to twenty-two and three-quarters per cent. The defendant then assumed to discharge in full its obligation for such arrearage when it paid a dividend declared to be "in the amount of $22.75 per share" of which the media of payment were two-fold—a small portion thereof was paid in cash, the balance was paid by distributing to preferred stockholders income notes issued by two of the defendant's wholly owned subsidiaries. Having had no notice of the defendant's plan thus to discharge its obligation to its preferred stockholders and never having consented thereto, the plaintiff retained that portion of the dividend paid in cash but rejected and returned to the defendant the income notes. It is the plaintiff's claim that to the extent of the face value of the income notes the dividend was illegally declared and did not satisfy the defendant's legal obligation to her as a preferred stockholder.

The Appellate Division has unanimously affirmed the judgment at Special Term dismissing the plaintiff's complaint upon the merits. Upon the record, which is now before us by our leave, the plaintiff asks a diversity of relief—to a portion of which we believe she has established her right in equity.

The defendant is engaged in the lumber business in New York City. Its capital structure includes, in addition to other classes of junior stock, 7,500 shares of first preferred seven per cent cumulative stock of $100 par value. The first preferred stock is not widely distributed. Its entire amount is held by forty-one owners, one of whom is the plaintiff, who owns 515 shares. Between May 1, 1930, and April 30, 1935, the defendant suffered serious operating losses which impaired its working capital and caused the suspension of dividends on the first preferred stock from May 1, 1932, until July 31, 1935. In the fall of the latter year dividends on the first preferred stock were resumed and were paid for more than a year. Meantime, however, there remained unpaid the arrears in dividends on the first preferred stock for prior years.

In the latter part of 1936 the business of the company improved and was such that its directors apparently anticipated earnings in excess of regular dividend requirements on the first preferred stock for the fiscal year ending April 30, 1937. We are told they were also aware that unless such earnings were paid out as dividends the company would be subject to a high surtax under the Federal undistributed earnings tax. As there were then due and unpaid upon the preferred stock twenty-two and three-quarters per cent of accumulated dividends, any dividends declared were required to be paid upon that stock. It was also determined by the company's executives that its liquid assets had been so impaired and its bank indebtedness was so great that cash

dividends sufficient to satisfy the Federal tax law were inadvisable. It was in those circumstances and in an effort to pay the arrears of dividends on the first preferred stock without disturbing the company's needed liquid capital that the defendant's board of directors took the action which the plaintiff claims adversely affected her rights as a holder of first preferred stock and led to the present controversy.

On April 16, 1937, when the accumulated arrears of dividends upon 515 shares of first preferred stock owned by the plaintiff was $22.75 per share, amounting in all to $11,716.25, the defendant's board of directors adopted the following resolution: "Resolved, that a dividend in the amount of $22.75 per share be and the same hereby is declared upon the first preferred stock of this corporation, distributable to the holders of record of such stock as of the 20th day of April, 1937."

Thereafter, but at the same meeting, the board adopted another resolution which made provision for the payment of the dividend of "$22.75 per share," theretofore declared, by distributing to the preferred stockholders for each share owned, two dollars and seventy-five cents in cash and twenty dollars face amount of fifty-year income notes issued by the defendant's subsidiaries. The resolution directing such payment was as follows:

"Resolved, that the dividend, in the amount of $22.75 per share declared upon the first preferred stock of the corporation and amounting to a total of $170,625.00 on the 7,500 shares of first preferred stock outstanding, be paid by the pro rata distribution to the holders of such stock of the following:

"$100,000 principal amount of 5% 50 year income notes of Adams, Fowler & Hoffman, Inc.

"$50,000 principal amount of 5% 50 year income notes of R. B. Everett Lumber Company, Inc.

"$20,625 cash."

In reference to the "income notes" of the defendant's two subsidiaries, which were to be distributed by the defendant at their face value, it should be said that in each instance the note states that the interest thereupon of five per cent is payable semi-annually, "if and only to the extent that the available net income, as that term is defined herein, of the [subsidiary] corporation shall suffice for such payment * * *."

The plaintiff, who resides in Denver, Col., had no notice of the dividend action by the defendant's board of directors until she received from the defendant a circular letter dated April 21, 1937, addressed to all holders of its first preferred stock, and inclosing to her a check in the amount of $1,416.25 and two fifty-year income notes issued and registered in her name—one fifty-year note of Adams, Fowler & Hoffman, Inc., of the face amount of $6,866.70, due April 30, 1987, and one fifty-year note of R. B. Everett Lumber Company, Inc., of the face amount of $3,433.30, due April 30, 1987. After advising her of the dividend action taken by defendant's board of directors and having reviewed the business experience of the defendant company and its subsidiaries, the letter stated in part:

"* * * The arrears in dividends on the First Preferred Stock of Cross, Austin & Ireland Lumber Company are 22¾% which on an issue of $750,000 amounts to $170,625. The clearing up of these arrears is the subject of this letter.

"It will be seen from the foregoing that the parent company in addition to owning all of the Common Stock of the two subsidiaries, has held their Fifty Year Income Notes in an aggregate amount of about $165,000. These notes are entitled to cumulative interest at 5%. There is good reason to believe that these companies, under the supervision and control of the parent company, will be profitable enterprises and under ordinary circumstances Cross, Austin & Ireland Lumber Company would continue to hold its entire investment in them.

"The Board of Directors has given earnest consideration to the problem of disbursing the company's earnings to avoid penalty taxation and at the same time conserve cash and has concluded that it is to the best interest of the company and the holders of First Preferred Stock alike, that the arrears on this stock be paid in full by the distribution of the major portion of the company's holdings of the Income Notes of Adams, Fowler & Hoffman, Inc. and R. B. Everett Lumber Company and a lesser amount of cash. Accordingly, the Board has voted a dividend of 22¾% on the First Preferred Stock payable to holders of record on April 20, 1937 in the following manner by check 2¾%, in Income Notes of Adams, Fowler & Hoffman, Inc., 13⅓% and in Income Notes of R. B. Everett Lumber 6⅔%. Check and notes in the correct amount duly drawn to the order of and registered in the name of the respective stockholders are enclosed herewith.

"Under the Federal Tax Law of 1936 dividends may be paid in money or property, payment in either form exempting the disbursing corporation from penalty taxation to the extent of such payments, provided distribution is made prior to the close of the fiscal year in which credit for payment is taken. Such dividends, whether in cash or property, must be fully reported as income by the recipient. You are, therefore, advised that the entire 22¾% should be included in your 1937 Income Tax Return as Current Income. You are requested to deposit check promptly, * *."

Being thus advised by the defendant that the fifty-year notes and cash were distributed to her in full payment of arrears of twenty-two and three-quarters per cent in dividends accrued upon the amount of preferred stock which she owned, and that she should report as taxable income not only the cash so received but also the face value of the income notes, the plaintiff promptly wrote the defendant that she had not consented to the method adopted by the defendant in its plan thus to make full payment of the arrears of twenty-two and three-quarters per cent in dividends then due upon her holdings of first preferred stock and that she would return the income notes and the amount of the check which she had received. In reply the defendant's president advised her by letter that "There would be no point in mailing back the certificates. The Company could not accept them except to hold them in safe keeping for your account * * *." Thereafter the plaintiff returned to the defendant the two income notes

which had been issued and registered in her name, having a total face value of $10,300 and which the defendant now holds for her for safe keeping.

Preferred stock issued by a stock corporation may grant to the stockholder a variety of rights depending largely upon the financial requirements of the corporation at the time the stock is issued. Whatever preferential rights and privileges may thus be granted to a stockholder, the law regards them as contractual. "The certificate of stock is the muniment of the shareholder's title, and evidence of his right. It expresses the contract between the corporation and his co-stockholders and himself; and that contract cannot, he being unwilling, be taken away from him or changed as to him without his prior dereliction, * *." Kent v. Quicksilver Mining Co., 78 N.Y. 159, 180; Roberts v. Roberts-Wicks Co., 184 N.Y. 257, 263, 77 N.E. 13, 3 L.R.A., N.S., 1034, 112 Am.St.Rep. 607, 6 Ann.Cas. 213.

In the case at bar the certificates of first preferred stock issued by the defendant and owned by the plaintiff stated the preferential rights to which she was entitled, which recital is in part as follows: "The First Preferred Stock, consisting of seventy-five hundred (7,500) shares of the par value of One Hundred Dollars ($100) each, shall be entitled to vote and to a seven per cent (7%) cumulative annual dividend * * *." Treating that statement as an expression by the defendant corporation of its contractual obligation to the plaintiff as an owner of its first preferred stock, we construe its language as the defendant's agreement to pay the plaintiff in cash cumulative annual dividends of seven per cent of its par value. Undoubtedly, in the event a corporation has a surplus, it is within the fair and honest discretion of its board of directors, uncontrolled by the courts, to determine whether a dividend shall be declared and if so whether it shall be paid in cash or property. Williams v. Western Union Telegraph Co., 93 N.Y. 162, 191, 192. Where, however, as in the instant case, a corporation has, by the issuance of preferred stock in accord with its charter provisions and applicable law, granted preferential rights and privileges to stock issued by it and the outstanding, it cannot disregard what the law regards as contractual obligations which it has thus undertaken in connection with its stock.

We do not find in the record at hand evidence of an effort by the plaintiff to interfere with any matter which is lawfully within the control of the defendant's board of directors. There is no charge by her of fraud or mismanagement; there is no effort on her part to compel the defendant to declare a cash dividend. Asserting only her contract rights as an owner of the defendant's first preferred stock, she refuses to accept in payment of arrears in dividends upon her holdings the fifty-year income notes already described. We agree with the plaintiff's position that the defendant's obligation to her as an owner of its first preferred stock may not legally be thus satisfied in the absence of her consent to such action. She cannot be compelled to accept a property dividend. Williams v. Western Union Telegraph Co., 93 N.Y. 162, 192. See Thompson on The Law of Corporations (3d ed.) vol. 7, § 5261. * * *

The letter of transmittal and her subsequent correspondence with the defendant's president not only gave her notice that the corporation offered her no choice whether as a first preferred stockholder she was willing to accept the income notes in part payment of arrears in dividends upon her stock but it notified her that the Federal Income Tax officials had been advised that she had been paid such arrears in dividends in full. By the action thus taken by the defendant, despite plaintiff's refusal to consent thereto, the defendant's corporate records show that she has been paid in full the amount of arrears of dividends accumulated as of April 20, 1937, upon her first preferred stock. So long as the fifty-year income notes of defendant's subsidiaries remain issued and registered in her name she is the ostensible owner thereof. The defendant's records will show payment of such arrears in accumulated dividends and her right in the future to receive such dividends in cash has been jeopardized and constitutes irreparable injury.

Likewise the information filed by the defendant with Federal Income Tax officials relating to the payment of the dividend declared on April 16, 1937, shows a payment of that dividend in full to the plaintiff who, in turn, has never reported the face value of the income notes among dividends received by her because she has refused to accept the same.

In these circumstances we believe Special Term erred in refusing to exercise its powers in equity in the plaintiff's favor. * * *

The judgments should be reversed, with costs to appellant, and the case remitted to the Special Term with directions to proceed in accord with this opinion.[16]

CROCKER v. WALTHAM WATCH COMPANY et al.

Supreme Judicial Court of Massachusetts, 1944. 315 Mass. 397, 53 N.E.2d 230.

Bill in equity by Percy G. Crocker against the Waltham Watch Company and others on behalf of plaintiff as minority stockholder, the company, and all other stockholders, to establish the obligation of the company and its directors to declare and pay dividends to the class A common stockholders and to declare and pay or accumulate dividends on the six per cent. preferred stock. From a decree dismissing the bill, plaintiff appeals.

Reversed and decree rendered for plaintiff

DOLAN, JUSTICE. This is a bill in equity against the Waltham Watch Company and its directors, brought by a minority stockholder of the defendant company in behalf of himself, the company and all other stockholders. The bill seeks a decree establishing the obligation of the company and its directors under its agreement of association to declare

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16 The Court of Appeals left open the question whether the directors intended to declare a cash or a property dividend. Plaintiff brought an action at law to recover the balance due on what she alleged was the cash dividend. Held: Judgment for defendant. The declaration of a dividend was clearly partly in cash and partly in property. Though such a declaration is invalid, the court cannot construe the resolution as calling for a cash dividend. Strout v. Cross, Austin & Ireland Lumber Co., 175 Misc. 826, 25 N.Y.S.2d 377, aff'd, 263 App.Div. 801, 32 N.Y.S.2d 127, 1941.

and pay dividends to the class A common stockholders and to declare and pay or accumulate dividends on the six per cent preferred stock annually whenever the operations of the defendant company result in annual net earnings, and establishing the obligation of the directors to declare and pay dividends on the common stocks class A, and to declare and pay or accumulate dividends upon the six per cent preferred stock for the years 1939, 1940 and 1941. The pertinent parts of the agreement of association are annexed to and made a part of the bill. The case was heard upon statements of agreed facts, which the parties agreed are all the facts. The judge entered a decree dismissing the bill, from which the plaintiff appealed.

A summary of the facts follows: The plaintiff is the owner of nine hundred shares of the six per cent preferred stock of the defendant company, and has owned these shares continuously since the reorganization to be mentioned hereinafter. The individual defendants are the directors of the company and were the directors during the years 1939, 1940 and 1941. The company was organized and incorporated in Massachusetts in 1923 to succeed to the watchmaking business of a predecessor company of the same name. The old company met serious financial difficulties at the end of the last war, having accumulated a large inventory, much of which was obsolete and overvalued. It had little cash and was forced to resort to bank loans and public offerings of five-year coupon notes to keep going, meanwhile continuing to operate at a loss. The old company exhausted its borrowing power and could obtain no further extensions on its bank loans, and despite all efforts continued to lose money until the bank creditors approached Kidder, Peabody & Co. to undertake a financial reorganization. The assets of the old company were sold to the new defendant company in 1923; the new company assumed the debts of the old company and procured cash to liquidate the $7,200,000 of bank loans and publicly held coupon notes by the sale for $5,300,000 of the bonds, debentures, and a portion of the six per cent preferred stock of the new company, by the issue of $1,700,000 of prior preference stock for subscription at par by the old preferred stockholders, and by the issue of common stock, class A, for $250,000. For full details of the reorganization, see Abbot v. Waltham Watch Co., 260 Mass. 81, 156 N.E. 897.

Since the date of the reorganization, the financial position of the new company has steadily improved. Earnings have been sufficient to enable the company to retire its debentures without refinancing, and to purchase and retire substantial amounts of its mortgage bonds and stocks, so that on December 31, 1941, there were outstanding the following securities: $1,130,000 of mortgage bonds due June, 1943; prior preference stock of a par value of $381,230; six per cent preferred stock of a par value of $3,384,285; twenty-five thousand shares of no par value common stock, class A; and forty-one thousand eight hundred sixty-eight and three fourths shares of common stock, class B, no par value.

The pertinent provisions of the agreement of association and articles of organization of the company follow: "Second: Holders of prior preference stock shall be entitled to receive, when declared by the

Directors, cumulative dividends at the rate of 7% per annum and no more. * * * No dividends shall be paid on any other class of stock until all accrued dividends and the current quarterly dividend on the prior preference stock shall have been paid, or a sufficient sum from which to make payment when due shall have been set aside for that purpose. Third: Holders of preferred stock shall be entitled to receive, when declared by the Directors, dividends at the rate of 6% per annum and no more payable before any dividends are paid on the common stock in any year, except as hereinafter provided in the case of common stock Class A. Such dividends shall be noncumulative except as hereinafter provided. Fourth: Holders of common stock, Class A, will be entitled to receive each year in dividends an amount equal in the aggregate to one-fifth of the net earnings of the Company for the preceding year, to be determined as follows: At the end of each calendar year the Directors shall ascertain the annual net earnings for the preceding year remaining after the payment of all interest charges, accrued and unpaid dividends on the prior preference stock and after providing during the first five years for the annual sinking fund, to retire the debentures dated February 15, 1923, and shall forthwith declare and pay to the holders of the common stock, Class A, a dividend equal in amount to one-fifth of such net annual earnings, provided the Company's capital will not be impaired by such payment. If the Company's capital will be so impaired, then the Directors shall forthwith declare and pay a dividend to the holders of the common stock Class A, of so much of the one-fifth of such net annual earnings as may be paid without impairing the Company's capital. The rights of the holders of common stock, Class A, to the dividends above provided for shall be non-cumulative. If a dividend as above stated is paid on the common stock, Class A, in any year, there shall either be paid in the same year, on the preferred stock a dividend equal in amount to four times the dividend paid on the common stock, Class A, but not exceeding an amount equal to 6% per annum on the preferred stock outstanding, or if such dividend is not paid during the same year, it shall be accumulated, and no dividends shall be paid on the common stock, Class B in any year unless such accumulated dividend on the preferred stock is paid as well as the dividends on the preferred stock for such year. * * * Ninth: All the stock, both preferred and common, shall have equal voting powers, each share entitling the holder to one vote."

During the years 1939, 1940 and 1941, the company had an earned surplus and, after the payment of taxes and all charges, had earnings in excess of the amount necessary to pay all accrued dividends on the prior preference stock. The figures for 1939 and 1940 are shown in the balance sheets and earnings statement for these years attached to the record. No figures were available for 1941 when the statement of agreed facts was prepared. All cumulative dividends on the prior preference stock for the years 1939, 1940 and 1941 have been paid. It is conceded that after such payments net earnings were sufficient in those years for the declaration and the payment of a dividend in some amount on the common stock, class A, and on the six per cent preferred stock; that during the years in question there has been no

impairment of capital in the sense of "contributed capital" or "capital represented by outstanding capital stock"; and that out of the earnings of each of the three years dividends in some amount could have been declared and paid on the class A common stock and on the six per cent preferred stock without causing an impairment of capital in that sense. At the close of each of the years in question the directors have ascertained the amount of earnings remaining after provision for accrued dividends on the prior preference stock, but have determined to declare no dividends on the class A common or the six per cent preferred stock.

The parties are agreed that the sole issue is whether, under the agreement of association and articles of organization set out above it is within the discretion of the directors to declare no dividends on the common stock, class A, and on the six per cent preferred stock in years in which there are an earned surplus and net earnings of the prior year available therefor, or whether, as the plaintiff contends, the agreement of association makes a declaration mandatory in such circumstances. If the declaration of dividends be held discretionary, the plaintiff does not charge abuse of discretion.

It is well settled that a stockholder's rights between himself and the corporation and the other stockholders are contractual, and that the terms of the contract are to be found in the agreement of association and the provisions of applicable statutes. [Citing cases.] * * * Therefore it is to the agreement of association, particularly clause fourth thereof, that the court must look for a determination of the plaintiff's right to receive and the defendants' duty to declare dividends.

The cases in this Commonwealth as well as those of other jurisdictions reveal, in general, a reluctance on the part of the courts to construe provisions relative to the declaration of dividends in such a way as to hold that it is mandatory upon the directors in any circumstances to declare dividends. The courts prefer not to interfere thus with the sound financial management of the corporation by its directors, but declare as a general rule that the declaration of dividends rests within the sound discretion of the directors, refusing to interfere with their determination unless a plain abuse of discretion is made to appear. * * *

This principle is applicable with equal force to the rights of holders of preferred shares, whether cumulative or noncumulative, to receive dividends. The cases just cited were all cases of preferred stock. In Morse v. Boston & Maine Railroad, Wabash Railway Co. v. Barclay, and Collins v. Portland Electric Power Co., just cited, the shares in question were all noncumulative preferred shares. See also New York, Lake Erie & Western Railroad Co. v. Nickals, 119 U.S. 296, 307, 7 S.Ct. 209, 30 L.Ed. 363. As was said in the Collins case, 12 F.2d 671, 673: "Preferred stock does not represent a debt nor a pledge of profits in favor of the holders thereof in preference to others." * * *

The only Massachusetts case which we have been able to discover where the language of the contract, contained in a by-law, was found to impose an obligation on the corporation to pay dividends is Lydia

E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 20 N.E.2d 482. The text of the by-law is set forth in 303 Mass. at pages 11, 12, 20 N.E.2d at page 489. In Cratty v. Peoria Law Library Association, 219 Ill. 516, 76 N.E. 707, the court held that the following by-law made the payment of dividends mandatory. The by-law there in issue provided: "The association guarantees to every stockholder a dividend of eight per cent. per annum on the amount of paid-in stock held by him or them from the date of such payment, which dividend shall be a charge against the association, and the production of the certificate of stock or receipt of payment shall entitle the holder to the amount of such dividend. Such dividend shall be due and payable on the first day of January in each year." The court there held that "It certainly cannot be said that the parties to this contract intended that it should not be performed if the corporation preferred to expend its net income in increasing the capital or assets by adding to the library and rendering it more useful and valuable." Page 523 of 219 Ill., page 709 of 76 N.E. * * *

In the case at bar the defendants argue that the apparently mandatory language of clause fourth of the agreement of association must nevertheless be held to leave the matter of dividends out of net profits on the common stock, class A, and on the six per cent preferred stock within their judgment. They strongly stress the predilection of the courts for such a construction and rely upon the apparent inconsistency that will exist between that clause and clause second relating to dividends on the prior preference stock if the plaintiff's interpretation be the one adopted. Clause second reads: "Holders of prior preference stock shall be entitled to receive, when declared by the Directors, cumulative dividends at the rate of 7% per annum and no more, commencing to accrue on the 12th day of March, 1923, and payable July 1, 1923, and quarterly thereafter on the first days of January, April, July and October in each year. No dividends shall be paid on any other class of stock until all accrued dividends and the current quarterly dividend on the prior preference stock shall have been paid, or a sufficient sum from which to make payment when due shall have been set aside for that purpose."

It is argued by the defendants and conceded by the plaintiff that the declaration and the payment of dividends on the prior preference stock are expressly made subject to the directors' discretion. Yet both accrued and current dividends on that stock must be paid before any dividend may be declared on any other class of stock. From this the defendants maintain that the declaration or the payment of dividends on the common stock, class A, and on the six per cent preferred stock must be discretionary with the directors. In our opinion, however, the language of clause fourth of the agreement of association is so direct and express that we cannot escape the conclusion that it requires the directors to declare dividends out of net earnings of the preceding year in the amount and under the terms stipulated on the common stock, class A, and on the six per cent preferred stock. It is difficult to conceive of words more direct and expressive of command than the following language used in this clause: "At the end of each

calendar year the Directors shall ascertain the annual net earnings for the preceding year * * * and shall forthwith declare and pay to the holders of the common stock, Class A, a dividend * * * provided the Company's capital will not be impaired by such payment. If the Company's capital will be so impaired, then the Directors shall forthwith declare and pay a dividend to the holders of the common stock, Class A, of so much * * *."

"Shall forthwith" suggests immediacy and necessity; it is expressive of the imperative; it negatives any suggestion of discretion or determination of policy by the directors. The entire clause suggests irresistibly that the policy of the directors with regard to net earnings has been fixed and declared for them beyond their power to alter. In short, it is apparent that the incorporators determined to dedicate a certain amount of such net earnings as the company might have to the payment of dividends on the class A common and on the six per cent preferred shares of the company.

Further support for this conclusion is found, as it was found in Burk v. Ottawa Gas & Electric Co., 87 Kan. 6, 123 P. 857, Ann.Cas. 1913D, 772, in the fact that when it was intended to confer discretion on the directors in the matter of dividends the draftsman of the agreement knew how to, and did, employ suitable language. Thus, when it comes to declaring dividends on the common stock, class B, clause fifth provides that "Any earnings at any time applicable to the payment of dividends after the payment of the dividends in respect of the prior preference stock, preferred stock and common stock, Class A, hereinbefore specified, may be applied to the payment of dividends on the common stock, Class B. * * *" One has but to contrast the phrase "shall forthwith declare and pay" with the words "may be applied to the payment" to ascertain the obvious difference of intent expressed in the two clauses of the agreement.

The history of the origin of the defendant company tends to indicate that the plaintiff's construction of the agreement of association is the true one. The common stock, class A, and the six per cent preferred shares were sold to the public as the issue of a company succeeding to the business of a failing concern, in an effort to raise new capital for the business. It seems most likely that new investors in a business whose future was certainly speculative could not be induced to risk their money in the new company except upon the assurance that if operations should result in net earnings they, the investors, would definitely receive a share of these earnings. In view of the risky nature of the investment it seems most probable that purchasers of the shares put their entire hopes in a share of any net earnings that might result; that the possibility of permanently augmenting their wealth was sufficiently remote at the time for them to be unwilling to permit the directors to accumulate a large surplus or plow all the earnings back into the business while they, the investors, were foregoing any return on their investment during years when such return was possible. * * *

It is not difficult to reconcile this construction of clause fourth with the provisions of clause second dealing with the payment of dividends

on the prior preference stock. Reading the agreement of association as a whole, the interpretation suggested by the plaintiff seems the one most likely to have been truly intended by the incorporators. It brings all the provisions into harmony with each other, and gives effect to each clause without altering the meaning most naturally to be placed upon the words employed in each. And it is neither strained nor artificial. The plaintiff's interpretation is, briefly: In years when there have been no net earnings the directors may in their discretion pay dividends on the prior preference stock out of accumulated surplus, or they may pass them; likewise in years when earnings are meager and insufficient to pay a dividend on the prior preference stock and leave anything more. Similar discretion in like circumstances is granted to the directors by clause third with reference to the payment of noncumulative dividends on the six per cent preferred stock. But in years when the operations of the company result in net earnings sufficient, after the payment of certain prior charges, to pay a dividend on the prior preference stock with something left over, then a dividend on the prior preference stock must be declared and paid or a sufficient sum therefor set aside, and, further a dividend of the stipulated portion of the remainder declared and paid to the holders of the common stock, class A, and a cumulative dividend of a stated portion of such remainder declared in favor of the six per cent preferred shares.

Such an interpretation does not make it impossible for the directors ever to accumulate a surplus out of earning to guard against future contingencies, or to reinvest a part of the earnings in the business. In these years when net earnings remain after paying the dividends required on the prior preference, the six per cent preferred and the common, class A, stocks, whether or in what amount dividends shall be paid to the holders of the class B common stock is a matter for the determination of the directors. They may declare no dividends out of that balance or declare a dividend equalling less than the entire balance. The absolute rights of the holders of the common stock, class A, and of the holders of the six per cent preferred stock are limited to a stated share of net earnings in years when net earnings are available. There is nothing in the agreement of association that confers on any class of stockholders of the company a right to dividends out of earned surplus. Nor ought it to be held, in the absence of the clearest expression of intent, that the incorporators had so little regard for future contingencies that might arise that they drew an agreement making it impossible in any circumstances for the company to amass a surplus to provide for unforeseen emergencies or to tide the company over lean years. * * *

AFFELDT v. DUDLEY PAPER COMPANY et al.

Supreme Court of Michigan, 1943. 306 Mich. 39, 10 N.W.2d 299.

Suit by Ferdinand G. Affeldt against the Dudley Paper Company and others to compel defendants to pay plaintiff the par value of his shares

of preferred stock plus cumulative dividends. Decree for plaintiff, and defendants appeal.

Affirmed.

BUTZEL, JUSTICE. Plaintiff, the owner of 100 shares of the preferred stock of defendant Dudley Paper Company, filed a bill asking that defendants be ordered to pay him $1,000, the par value of his shares plus cumulative dividends at the rate of 7 per cent. per annum from September 1, 1934. Prior to the year 1931, plaintiff had become the owner of 100 shares of preferred stock. These shares were authorized by an amendment to the articles of association which provided that "the preferred stock shall be subject to redemption at par on the 15th day of April, 1935," etc., and at a premium at any time after April 15, 1916, and before April 15, 1935. During the year 1934, at the request of the officers of the corporation and upon their representation that the company would be financially unable to redeem the preferred stock on April 15, 1935, plaintiff exchanged his certificate for one dated September 1, 1934, for 100 shares of preferred stock of the par value of $10 a share. The certificate contained the following recitals:

"This stock is subject to redemption at par on April 15th, 1940, and at 5 per cent. above par at any time after November 17th, 1930 and before April 15th, 1940."

"The holder of this certificate shall be entitled to a dividend of 7 per cent. per annum, payable quarterly on the first days of January, April, July and October in each year, which dividend shall be cumulative and payable before any dividend shall be set apart or paid on the common stock."

While the exact date of the expiration of the corporate charter is not given, it was in the very early part of 1941, so that April 15, 1940, the date of redemption at par set forth in the certificate, was but shortly prior to the expiration of the corporate charter.

At the end of 1937, or soon thereafter, the officers of the corporation made an effort to exchange the 7 per cent. cumulative preferred stock for 5 per cent. noncumulative preferred stock. A meeting of the common stockholders was held for that purpose, and application was made to the Corporation and Securities Commission for authority to issue such 5 per cent. noncumulative stock, the purpose of the issuance of said stock being stated in the application as follows: "The proposed issue is not to be sold but is to be exchanged, share for share for the outstanding certificates of preferred, already issued by the company."

Plaintiff refused to make the exchange. He claims that he never received notice of any meeting of preferred stockholders in which the question of the issuance of the 5 per cent. stock and its exchange for the then outstanding stock was presented. Defendants concede that no proper legal action was taken at the time that would bind plaintiff so we need not discuss this phase of the case. As a matter of fact 4,578 shares of the 7 per cent. cumulative preferred stock were exchanged for 5 per cent. non-cumulative stock, but 340 shares of the 7 per cent. preferred stock were not exchanged. The holders of the 340 shares, with the exception of plaintiff holding 100 shares, accepted

the 5 per cent. dividend that was subsequently declared on the 5 per cent. non-cumulative preferred stock. Plaintiff did not accept such 5 per cent. dividend and has received no dividends on his stock since December 1, 1934. * * *

The more serious question is whether it was proper for the trial court to compel the payment of accumulated dividends. While it is true that a court is unwilling to impose its judgment upon the directors of a corporation and interfere with the exercise of their sound discretion, if the directors refuse to declare a dividend in the hope of compelling a stockholder to abandon his contract, the latter may have his remedy in equity. See Knight v. Alamo Manufacturing Co., 190 Mich. 223, 157 N.W. 24, 6 A.L.R. 789. The defendant corporation had already paid a 5 per cent. dividend on the outstanding 5 per cent. non-cumulative preferred stock and was prepared to pay an additional 5 per cent. dividend for the current year. As was stated in Vanden Bosch v. Michigan Trust Co., supra, all who accepted the new preferred stock did so with the understanding that the old holders must be paid to the extent they would not accept the substitution. Inasmuch as the corporation conceded its ability to pay dividends to the new preferred stockholders, it was its duty to take care of the old preferred stockholders first. See Wiedersum v. Atlantic Cement Products Co., 261 App.Div. 305, 25 N.Y.S.2d 496.

A question is raised as to whether the obligation should continue to pay the certificate rate of 7 per cent. after maturity. Counsel have been unable to find any authority on this subject. In Warner v. Juif, 38 Mich. 662, we said: "We are aware of the difference of judicial opinion which appears in regard to this general subject, but we think the matter is settled in this State in favor of the * * * rate * * * prescribed by the contract as well after maturity as before. Such has been the invariable construction here, not only by the profession, but by all others, and we are not disposed to question its propriety."

Defendants further object to the fact that there was an injunction restraining the declaration of a dividend of 5 per cent. on the new preferred stock. As stated in the brief, "The company had at the time of the trial current assets with a value approximately three times the amount of its current liabilities;" also that its net worth was over one hundred times the amount in litigation. It further stated that collection of the amounts due plaintiff was such a simple matter that the issuance of an injunction was entirely improper. The question of the propriety of issuing an injunction becomes moot. The affirmation of the decree requires its immediate payment. The injunction then ceases to be of any force or effect. Defendants claim that the costs were improperly assessed. We have checked them and find no error.

The decree of the trial court is affirmed, with costs to plaintiff.

NEW ENGLAND TRUST COMPANY et al. v. PENOBSCOT CHEMICAL FIBRE COMPANY, et al.

Supreme Judicial Court of Maine, 1946. 50 A.2d 188.

Suit by the New England Trust Company and others, against the Penobscot Chemical Fibre Company and others, to compel the payment of accumulated dividends on certain stock. From a decree in favor of complainants, the defendants appeal.

Appeal dismissed; decree affirmed.

THAXTER, JUSTICE. The plaintiffs, who are the holders of 1,618 shares out of a total of 2,500 of the second preferred stock of the Penobscot Chemical Fibre Company, on behalf of themselves and all other second preferred stockholders similarly situated, filed a bill in equity on May 15, 1945 against the Company and its directors to compel the payment of accumulated dividends on the stock which on March 31, 1945, the end of the fiscal year, amounted to $42 per share. Answers were filed by the defendants to which there were replications by the plaintiffs and a hearing was had on bill, answers and evidence. The sitting justice entered a decree sustaining the bill and ordering the payment of the accumulated dividends which on April 14, 1946, the date of the entry of the decree, had been reduced to $35 per share. The case is now before us on an appeal from this decree. * * *

On January 8, 1945 the plaintiffs, on behalf of themselves and all other second preferred stockholders, made written demand on the company and on the directors that all accumulated dividends on their stock should be declared and paid. No answer having been received to this demand, this action was brought.

The plaintiffs rely on the by-law relating to the second preferred stock, Par. (a) which reads as follows:

"Second preferred stock shall bear date of May 1, 1920, and shall be entitled to dividends at the rate of seven per centum per annum and no more, payable quarterly on the first days of August, November, February and May in each year hereafter.

"Such dividends shall be cumulative so that if on any such quarterly dividend date a dividend of 1¾ per centum of the par value shall not have been paid, the deficiency shall be paid before any dividends shall be declared, paid out, or set apart for any other class of stock, excepting Preferred Stock."

This by-law was enacted in 1920 and has remained in force to the present time exactly as originally worded with the exception that, apparently in 1937 at the time of the issuance of the prior preference stock, the second paragraph was amended to read as follows: "Such dividends shall be cumulative so that if on any such quarterly dividend date a dividend of one and three-quarters per cent (1¾%) of the par value shall not have been paid, the deficiency shall be paid before any dividends shall be declared, paid out or set apart for any class of junior stock."

The defendants contend that, in the absence of fraud, bad faith or abuse of discretion, their judgment not to pay dividends is conclusive

unless their discretion is limited by statute, charter or by-law. With this general principle we concur. It is a fact that the corporation has made large commitments for additional plant equipment and for improvements, the justification for which seems to be established. And the sitting justice has found that, if the directors had a discretion to withhold dividends on the second preferred stock, they exercised that discretion soundly.

A glance at the balance sheets of this company indicates that the payment of these dividends is not impossible as was the case in Spear v. Rockland-Rockport Lime Co., 113 Me. 285, 93 A. 754, 6 A.L.R. 793. Without doubt the money to do so could have been procured without imperiling the credit of the company, and it had the right to borrow money for that purpose. Hazeltine v. Belfast & Moosehead Lake Railroad Co., 79 Me. 411, 419, 10 A. 328, 1 Am.St.Rep. 330.

The question before us is a narrow one. On the facts of this particular case, were these plaintiffs entitled as a matter of right to these dividends, or did the directors have a discretion to withhold them?

As we have intimated above, we have no quarrel with the general rule that the declaration of dividends rests in the sound discretion of the board of directors of a corporation; but such discretion may be limited by a contract between the company and its stockholders, Spear v. Rockland-Rockport Lime Co., supra, or by a by-law which in effect constitutes such a contract. Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 13, 20 N.E.2d 482. Our court has gone farther than have some others in holding that the discretion of directors is limited when the preferred stock contract, as was the case here, provides without qualification that stockholders are entitled to dividends at a fixed rate. Spear v. Rockland-Rockport Lime Co., supra. In such a case the question is not, whether the directors in carrying out the financial policy of the company have acted wisely in withholding dividends, but rather what are the legal rights of the stockholders.

The question here involved was discussed in Spear v. Rockland-Rockport Lime Co., supra [113 Me. 285, 93 A. 755]. The preferred stock contract there before the court provided "That the preferred stock is entitled, out of the net earnings of the company, to a semiannual, preferential, cumulative dividend at the rate of 7 per centum per annum, and no more, payable on the 1st days of March and September in each year, to be paid or provided for before any dividend shall be set apart or paid on the common stock." Chief Justice Savage said, 113 Me. at page 289, 93 A. at page 756, 6 A.L.R. 793:

"The plaintiff's contract is that he shall be entitled, out of the net earnings of the company, to a semiannual, preferential, cumulative dividend, to be paid or provided for before any dividend is set apart or paid on the common stock. And that is why it is called preferential. By being cumulative, if net earnings at any dividend period are insufficient to pay the contract dividend, it is to be made up out of subsequent net earnings. And in any event, upon liquidation or dissolution of the corporation, the contract goes on to say, the preferred stockholders are to be paid in full for their stock at par, with all accrued and unpaid dividends, before common stockholders receive anything. One

feature of the contract remains to be noticed. The contract was that the preferred stockholder was entitled, out of the net earnings, to 'semiannual * * * dividends.' The defendant contends that, under this contract, the plaintiff was not entitled, even if there were net earnings, to have dividends paid for any half year, year, or series of years; that the directors might use the net earnings for the development of the business; and that there was but a single limitation, namely, that the plaintiff must be paid all accrued and unpaid dividends before anything is paid to common stockholders. In other words, it is claimed that the defendant made no promise or guaranty to the plaintiff of any dividends to be paid out of net earnings, at any particular time, and that it will have fully kept and performed the obligation of its contract, if at any time, past or future, it has paid or will pay the preferred dividends before common ones are paid; that is, it may indefinitely postpone payment. We are unable to concur in this view. This contract, like all others, must be interpreted in accordance with the expressed intention of the parties, reading the contract in the light of its purposes and existing conditions and surrounding circumstances. And, reading the contract in that way, we think it obvious that, when the parties agreed that the plaintiff was to be entitled, out of the net earnings, to a semiannual dividend, they intended that he should be entitled to have a dividend paid semiannually if there were net earnings."

Counsel for the defendants claim that the language quoted is dictum because the bill was in fact dismissed on the ground that the corporate property had been sold and there were no funds available from which payment of dividends could have been made. Conceding that technically the doctrine here laid down is dictum, it is nonetheless a statement as to how such a contract as we now have before us should be construed; and we cannot ignore it. It certainly means that preferred stockholders under such an agreement are as a matter of right entitled to dividends if they are earned, and that the directors do not have the right to postpone payment of them because in their judgment it is wiser to use the money required for their payment for extensions, rehabilitation and improvements. In reaffirming this principle we do not mean to imply that such right is an absolute one. Circumstances may exist which would justify the refusal to pay but they are not present in the instant case.

There is a cogent if not a compelling reason why this court should not now modify the doctrine so clearly laid down in the Spear case. Dictum though it may have been, it was a carefully worded and deliberate statement as to the rights of preferred stockholders. The by-law which we have before us was drafted within a few years after the opinion in the Spear case was handed down and the money may well have been paid to the corporation by the purchasers of the second preferred stock with the knowledge that under that by-law they were entitled, in accordance with the opinion of this court previously rendered, to semiannual dividends at the rate of seven percent, if there were net earnings of at least that amount applicable to such stock. In construing the language used in the contract involved in that case, the court said, 113 Me. at page 289, 93 A. at page 756, 6 A.L.R. 793: "And, if there is

any ambiguity in meaning, the contract should be construed more strictly against the company. The phraseology was its own, and it should be held to the significance which the words would ordinarily imply to an investor." We call attention to the fact that in the case now before us the language of the by-law with which we are dealing did have significance to the investors in this stock. It told them of their right to dividends if they were earned and on that understanding they paid their money to the corporation. For this court to change the rule after the money has been paid would in effect be to sanction a breach of faith.

We must therefore hold that under the contract between the company and the second preferred stockholders as expressed in the by-law the stockholders were entitled as of right to dividends if they were earned. * * *

It is strenuously argued that the corporation has insufficient cash with which to make this payment; that it has tried to borrow sufficient money and has failed. It did have sufficient funds at the time the suit was brought but we prefer not to rest our rejection of the defendants' contention on that ground. With such a favorable financial position as this balance sheet indicates, we frankly do not believe that there is no way that the relatively small amount necessary for this purpose can be procured. And we are fortified in that belief by the fact that in making the commitments for extensive improvements the directors must have determined that the money for such improvements could be raised. It is obvious that they feel it is wiser to use their funds and credit for improvements rather than to make the payment to these stockholders. In that they may be right as a matter of business policy but that is not the question before this court.

Appeal dismissed.

Decree below affirmed.

(c) Non-Cumulative Dividends

NON-CUMULATIVE DIVIDEND CLAUSE. (NO PAR VALUE)

The holders of the ——— stock shall be entitled to receive in each year, when and as declared by the board of directors of the corporation, out of any assets of the corporation available for dividends pursuant to the laws of the State of ———, preferential dividends at the rate of ——— Dollars ($———) per share per annum, and no more, payable annually, semi-annually or quarterly on such days as may be determined by the board of directors, before any dividends shall be declared or paid upon or set apart for the ——— stock for such year. Such dividends upon the ——— stock shall be non-cumulative, so that the holders of said stock shall be entitled to receive only such dividends not exceeding dividends at the rate of ——— Dollars ($———) per share, during any year, as may, in the unlimited discretion of the board of directors, be declared and made payable.

Whenever the full dividend upon the ——— stock at the rate of ——— Dollars ($———) per share per annum shall have been paid

or declared and a sum sufficient for the payment thereof set apart in any year, then dividends upon the ——— stock may be declared by the board of directors out of the remainder of the assets available therefor.

WABASH RAILWAY COMPANY, et al. v. BARCLAY et al. AUSTIN v. SAME.

Supreme Court of the United States, 1930. 280 U.S. 197, 50 S.Ct. 106.

Suit by John C. Barclay against the Wabash Railway Company and others. Decree for defendant [23 F.2d 691] was reversed by the Circuit Court of Appeals [30 F.2d 260], and the Wabash Railway Company and others and Shirley P. Austin separately bring certiorari. Reversed.

MR. JUSTICE HOLMES delivered the opinion of the Court.

This is a bill by holders of first preferred stock (called Class A) of the Wabash Railway Company, to have it declared that holders of such stock are entitled to receive preferential dividends up to five per cent. for each fiscal year from 1915 to 1926 inclusive to the extent that such dividends were earned in such fiscal years but were unpaid, before any dividends are paid upon other stock; and that the Company may be enjoined from paying dividends upon preferred stock B or common stock unless it shall first have paid such preferential dividends of five per cent. to the extent that the Company has had net earnings available for the payment and that such dividends remain unpaid. The case was heard upon bill and answer. The bill was dismissed by the District Court but the decree was reversed by the Circuit Court of Appeals, one of the Judges dissenting, 30 F.2d 260, and a writ of certiorari was granted by this Court. Wabash R. Co. v. Barclay, 279 U.S. 828, 49 S.Ct. 265, 73 L.Ed. 979.

The railway company was organized in 1915 under the laws of Indiana with three classes of capital stock: Shares of the par value of $100, of Five Per Cent. Profit Sharing Preferred Stock A; shares of the same par value of Five Per Cent. Convertible Preferred Stock B; and shares of the same par value of Common Stock. At the date of the bill there were 693,330.50 shares of A, 24,211.42 B and 666,977.75 common. From 1915 to 1926 there were net earnings on most of the years but for a number of years no dividend, or less than five per cent., was paid on Class A, while $16,000,000 net earnings that could have been used for the payment were expended upon improvements and additions to the property and equipment of the road. It is not denied that the latter expenditures were proper and were made in good faith, or that the money could not have been applied to dividends consistently with the duties of the Road. The Company now is more prosperous and proposes to pay dividends not only upon A but also on B and the common stock, but the plaintiffs say that it is not entitled to do so until it has paid to them unpaid preferential dividends for prior fiscal years in which it had net earnings that might have been applied to them but were not.

The obligations assumed by the Company appear in its instrument of incorporation and in the certificates of Preferred Stock A in substantially the same words "The holders of the Five Per Cent. Profit Sharing Preferred Stock A of the Company shall be entitled to receive preferential dividends in each fiscal year up to the amount of five per cent. before any dividends shall be paid upon any other stock of the Company, but such preferential dividends shall be non-cumulative." In the event of a liquidation the holders "shall be entitled to be paid in full out of the assets of the Company the par amount of their stock and all dividends thereon declared and unpaid before any amount shall be paid out of said assets to the holders of any other stock of the Company." By the plain meaning of the words the holders "are not entitled, of right, to dividends, payable out of the net profits accruing in any particular year, unless the directors of the Company formally declare, or ought to declare, a dividend payable out of such profits"; in the first instance at least a matter for the directors to determine. New York, Lake Erie & Western R. R. Co. v. Nickals, 119 U.S. 296, 307, 7 S.Ct. 209, 30 L.Ed. 363.

We believe that it has been the common understanding of lawyers and business men that in the case of non-cumulative stock entitled only to a dividend if declared out of annual profits, if those profits are justifiably applied by the directors to capital improvements and no dividend is declared within the year, the claim for that year is gone and cannot be asserted at a later date. But recently doubts have been raised that seem to have affected the minds of the majority below. We suppose the ground for the doubts is the probability that the directors will be tempted to abuse their power, in the usual case of a corporation controlled by the holders of the common stock. Their interest would lead them to apply earnings to improvement of the capital rather than to make avoidable payments of dividends which they do not share. But whether the remedies available in case of such a breach of duty are adequate or not, and apart from the fact that the control of the Wabash seems to have been in Class A, the class to which the plaintiffs belong, the law, as remarked by the dissenting Judge below, "has long advised them that their rights depend upon the judgment of men subject to just that possible bias."

When a man buys stock instead of bonds he takes a greater risk in the business. No one suggests that he has a right to dividends if there are no net earnings. But the investment presupposes that the business is to go on, and therefore even if there are net earnings, the holder of stock, preferred as well as common, is entitled to have a dividend declared only out of such part of them as can be applied to dividends consistently with a wise administration of a going concern. When, as was the case here, the dividends in each fiscal year were declared to be non-cumulative and no net income could be so applied within the fiscal year referred to in the certificate, the right for that year was gone. If the right is extended further upon some conception of policy, it is enlarged beyond the meaning of the contract and the common and reasonable understanding of men.

Decree reversed.

NOTE

This decision represents the majority rule in this country today. It has been the subject of much comment in the law reviews. See, Hicks, The Rights of Non-Cumulative Preferred Stock—A Doubtful Decision by the United States Supreme Court, 1931, 5 Temple L.Q. 538; Lattin, Is Non-Cumulative Preferred Stock in Fact Preferred? 1930, 25 Ill.L.Rev. 148–154; Stevens, Rights of Non-Cumulative Preferred Stockholders, 1934, 34 Col.L.Rev. 1439, 1445–1447; Notes, 1929, 14 Corn.L.Q. 341; 1930, 25 Ill.L.Rev. 330; 1929, 77 U. of P.L.Rev. 897; 1929, 3 St.John's L.Rev. 284; 1929, 38 Yale L.J. 820; comments on the Court of Appeals decision, 30 F.2d 260, C.C.A.N.Y. 1929; 1930, 10 B.U.L.Rev. 404; 1930, 18 Calif.L.Rev. 318; 1930, 30 Col.L.Rev. 260; 1930, 43 Harv.L.Rev. 829; 1930, 28 Mich.L.Rev. 763; 1930, 14 Minn.L.Rev. 417; 1930, 8 N.Y.U.L.Q.Rev. 138; 1930, 39 Yale L.J. 581.

The following cases represent the minority rule:

MORAN v. UNITED STATES CAST IRON PIPE AND FOUNDRY COMPANY.
DAY v. SAME.

Court of Chancery of New Jersey, 1924. 95 N.J.Eq. 389, 123 A. 546.

Bills by Anson B. Moran and John Day against the United States Cast Iron Pipe & Foundry Company. Bill of first complainant dismissed, and decree for other complainant advised.

BACKES, V. C. There has been no material change in the subject-matter of this litigation since the decision in 1908 in Bassett v. U. S. Cast Iron Pipe & Foundry Co., 74 N.J.Eq. 668, 70 A. 929, affirmed 75 N.J.Eq. 539, 73 A. 514.

It will be recalled that at that time the company had a reserve fund, accumulated by withholding dividends from its preferred and common stockholders, which, though listed on the books as "Reserve for Additional Working Capital," was held to be surplus profits and not working capital in the statutory sense of section 47 of the Corporation Act [2 Comp.St.1910, p. 1629], and that so much thereof as was derived from withholding dividends from the preferred stockholders was held to be available for division among them; that is to say, whenever in the opinion of the directors it was no longer needed for the purpose for which it was reserved and they in their discretion saw fit to divide it. The character of that fund remains the same, except that its book title is now "Working Capital Reserve," and the respective amounts composing the fund withheld from the two classes of stock have changed. At the end of the fiscal year 1922, the amount of dividends withheld from preferred stock was $700,000; from common stock $1,800,000, in round figures. The outstanding capital stock is now $12,000,000 preferred, 7 per centum, noncumulative, dividends, and $12,000,000 common.

The company's earnings during the year 1922 were over a million dollars, and after paying a dividend of 5 per cent. ($600,000) on the preferred stock the balance ($559,595.75) was transferred to the working capital reserve. Later a further dividend of 2 per cent.

was declared for the year 1922, and the amount ($240,000) was withdrawn from the working capital reserve to pay it. On November 16, 1923, the company resolved to pay to the preferred stockholders an additional dividend of one-half of 1 per cent., and a like dividend of one-half of 1 per cent. to the common stockholders, and drew upon the working capital reserve for the amount ($120,000). The resolution declaring the dividend on the preferred stock recites that it was out of earnings withheld from the preferred stockholders in previous years and was no longer needed as working capital, and the one declaring the dividend on the common stock, after setting forth the fact that a dividend of 7 per cent. had been paid to the preferred stockholders for the year 1922 out of the profits of that year, states that it is out of the net earnings for the year 1922. At this juncture the complainant Moran, a common stockholder, filed his bill to enjoin the payment of the additional dividend to the preferred stockholders, and the complainant Day, a preferred stockholder, filed his bill to prevent the payment of the dividend declared on the common stock.

The Moran bill: The complainant, a common stockholder, contends that the company having paid 7 per cent. in dividends on the preferred stock for the year 1922—the yearly maximum fixed by its charter—it was unlawful to declare the extra dividend of one-half of 1 per cent. out of withheld dividends of prior years because the charter limits the payment of dividends in any one year to 7 per cent. The certificate of incorporation fixes the yearly dividend at not to exceed 7 per centum.

Section 18 of the Corporation Act of 1896 (P.L. p. 283) provides, as to preferred stock, that——

"The holders thereof shall be entitled to receive, and the corporation shall be bound to pay thereon, a fixed yearly dividend, to be expressed in the certificate, not exceeding eight per centum, payable quarterly, half yearly or yearly, before any dividend shall be set apart or paid on the common stock."

This obviously means, as to noncumulative dividends, that out of the profits of any fiscal year not more than the percentage fixed by the charter shall be paid on such stock for such year, but it does not prohibit the company, after having paid the fixed yearly dividend, from, in the same year, declaring and paying additional dividends out of profits earned in prior years applicable to dividends for such years, and which, but for holding them in reserve for economic reasons, would have been distributed in dividends in those years. These profits belong primarily to the preferred stockholders, and the directors are in no wise restricted either as to amount, time, or occasion when distribution shall be made.

It has been suggested that the withheld profits are available only for dividends in lean years to make up deficiencies, and that was the effect of the opinion in the Bassett case. That situation was involved, but the point was not.

The resolution declaring the dividend is lawful, and the bill will be dismissed.

The Day bill: This bill is by a preferred stockholder to prevent the payment of the dividend declared on the common stock "out of the profits of 1922." The dividend was declared after the company had paid 7 per cent. on the preferred stock for that year. The point made is that no dividend can be declared on the common stock until all the withheld profits applicable to dividends on the preferred stock have first been divided and paid.

It will be observed that section 18 provides not only that preferred stockholders shall be entitled to receive, and the corporation shall be bound to pay, a fixed yearly dividend, but also declares that such dividend shall be paid "before any dividend shall be set apart or paid to the common stock." The quoted language is unmistakable and the reason for it is aptly demonstrated in the present effort of the board of directors to favor the common stock at the expense of the preferred stockholders. While the statute says that the preferred stockholders shall be entitled to receive and the company shall be bound to pay a fixed yearly dividend out of the profits, when that obligation is to be performed is largely a matter of discretion with the directors. They are at liberty to pass dividends year after year and pile up profits, if in their opinion it is for the welfare of the company that this be done—as was done here—and in the absence of fraud, actual or constructive, their judgment is controlling. But once having decided to divide the profits, duty supplants discretion, and it becomes incumbent upon the directors to discharge the company's obligation to pay the fixed yearly dividends, and this before any dividend shall be set apart or paid on the common stock, viz.: To holders of cumulative dividend shares, all arrearages; to holders of noncumulative dividend stock, the dividends withheld. Otherwise, if the action of the defendant company were sanctioned, and the directors pursued the course they have outlined, the rights of the preferred stockholders in the reserve profits could be indefinitely ignored and altogether subordinated to those of the common stock. Although each class has a definite sum in the reserve and one cannot encroach on the other's for dividends, the preferential right of payment of dividends assured by the statute cannot be disregarded. The statutory design was to meet just such a situation as here confronts the preferred stockholders. The legislative scheme was to protect them in their priority rights to dividends over the common stock in all events, and where, as here, profits of past years applicable to dividends on both preferred and common stock are held in reserve, or there are current profits applicable to dividends on common stock, it was conceived that this protection would be afforded for forbidding the payment of any dividends on the common stock until the amount due the preferred stockholders was first paid. The statute in this respect is nothing more or less than a definition of the equitable rights of the preferred stockholders arising out of the company's obligation to pay the yearly fixed dividend, for if the company had profits not needed in its business, and was about to distribute them among the common stockholders when it owed dividends on the preferred stock, a court of equity would enjoin the diver-

sion, just as it would intervene in behalf of creditors of a corporation when dividends are in derogation of their rights.

The fact that the dividend was declared out of the profits of 1922 adds no merit. The profits of that year had been in fact transferred to the working capital reserve, and the amount of the dividend was later withdrawn to meet it; but that is unimportant. The profits of 1922 were bulk surplus profits, by whatever name, and, as Vice Chancellor Howell observed, mere bookkeeping entries cannot change their character. The dividend cannot be differentiated because it was out of the profits of the last fiscal year any more than if it had been declared out of the profits of any preceding year and carried in the working capital reserve.

The defendant company's conception of section 18 is illustrated by the stock preference clauses contained in the certificate of incorporation, which read as follows:

"The preferred stock shall be entitled out of any and all surplus net profits, whenever declared by the board of directors, to noncumulative dividends at a rate not to exceed seven per cent. (7%) per annum for the fiscal year beginning on the first day of June, 1899, and for each and every other fiscal year thereafter, payable in preference and priority to any payment of any dividend on the common stock for such fiscal year. In the event of the dissolution of the corporation the holders of the preferred stock shall be entitled to receive par value of their preferred shares out of the surplus funds of the corporation remaining after the payment of its debts, before any payment shall be made therefrom to the holders of the common stock. The common stock shall be subject to the prior rights of the holders of the preferred stock as herein declared. If after providing for the payment of full dividends for any fiscal year on the preferred stock there shall remain any surplus net profits for such year, any of such net profits of such year and of any other fiscal year, after full dividends shall have been paid on the preferred stock shall be applicable to such dividends upon the common stock as from time to time shall be declared by the board of directors; and out of any such surplus net profits, after the closing of any fiscal year, the board of directors may pay dividends upon the common stock of the corporation for such fiscal year, but not until the dividends upon the preferred stock for such fiscal year shall have been actually paid or provided for and set apart."

This interpretation, if such it be, is, in effect, that noncumulative dividends are entitled to precedence only in years for which dividends are declared on the common stock out of profits of such years sufficient to pay dividends on both preferred and common stock, and not for years when applicable profits are available but undivided. The view is manifestly too narrow, for in the favored circumstances the preferred stock would be, as a matter of course, entitled to priority because of, as has already been pointed out, the company's bounden duty to pay the preferred stockholder a fixed yearly dividend. The fixed yearly dividend is the measure of their income per year out of profits per year, and the obligation of lean years is not met by pre-

ferential payments in fat years. Sight is lost entirely of the specific subordination of all dividends on the common stock.

Section 18 was amended in 1901 (P. L. 1901, p. 245, § 1), and in respect of dividends on preferred stock it provides:

"And such dividends may be made payable before any dividends shall be set apart or paid on the common stock, and such dividends may be made cumulative; provided, the corporation shall set apart or pay the said dividends to the holders of noncumulative preferred stock before any dividends shall be paid on the common stock."

The preservation of the priority right of noncumulative dividends, it would seem, emphasizes the view here entertained that the Legislature intended that no profits were to be divided among common stockholders, whatever may have been their origin or however applicable, unless the company's obligation to the preferred stockholders was first discharged.

The statutory ban on payments of dividends on the common stock until the preferred stockholders have been awarded their just due is explicit and imperative. The preference clauses in the certificate of incorporation in so far as they are thus inconsistent with the statute are invalid. Section 8, par. 7, C.S. 1910, p. 1604.

The dividend under consideration is without warrant in law and will be enjoined.[17]

CINTAS v. AMERICAN CAR & FOUNDRY COMPANY.

Court of Chancery of New Jersey, 1942. 131 N.J.Eq. 419, 25 A.2d 418.

Suit by Oscar B. Cintas against American Car and Foundry Company to restrain the payment of a dividend to common stockholders in violation of complainant's rights as a preferred stockholder.

Decree in accordance with opinion.

KAYS, VICE CHANCELLOR. The bill of complaint in this case is a class bill filed by the complainant who owns 2,500 shares of seven per cent. noncumulative preferred stock and 300 shares of common stock of the defendant corporation. The purpose of the bill is to protect complainant's rights as a preferred stockholder.

The matter first came before me on application for an ad interim restraint to prevent the payment of a dividend to the common stockholders which payment, it is claimed, would violate the rights of the preferred stockholders. Since hearing the motion, counsel have stipulated that I decide the whole case on the pleadings, affidavits and a stipulation entered into by counsel.

From the pleadings, affidavits and stipulation it appears that the defendant, American Car and Foundry Company, was organized under the laws of this State on February 20, 1899. It acquired eighteen manufacturing plants all of which are situated in the eastern part of the United States. The principal business of the defendant has been the manufacture of railroad cars and equipment and, at the present time, the manufacture of tanks, armorplate shells and other material for the United States and Great Britain. The defendant has acquired or established several subsidiaries which are as

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17 Aff'd, 96 N.J.Eq. 698, 736, 126 A. 302, 329, 1924.

follows: American Car and Foundry Export Company, American Car and Foundry Investment Corporation, Carter Carburetor Company, American Car and Foundry Securities Corporation, American Welding Company, Railway Equipment Company of Argentine, Railway Equipment Company of Brazil, Railway Equipment Company of Cuba, and American Car and Foundry Company, Ltd., of England. The above are foreign corporations in that they are not incorporated under the laws of this State. All the stock of these companies is owned either by the defendant or one of its other subsidiaries. The officers and directors of the subsidiaries have been officers, directors or employees of the defendant. In most instances the principal offices of said companies are at the principal office of the defendant in New York City. The books, records and accounts of the subsidiaries have been kept by the auditing department of the defendant although separate records and accounts have been maintained by each subsidiary as if it were in fact a separate entity as, in law, it is.

The capital of the defendant, at the time of its corporation, consisted of 300,000 shares of seven per cent. non-cumulative stock of the par value of $100 each and 300,000 shares of common stock of the par value of $100 each. The certificate of incorporation was amended in the year 1925 and thereby the 300,000 shares of common stock of the par value of $100 each was changed to 600,000 shares of no par value. The portion of the amended certificate, which effected this change, reads as follows:

"The Preferred Stock shall be entitled out of any and all surplus net profits, whenever declared by the Board of Directors, to non-cumulative dividends at the rate of not to exceed seven (7) per cent. for each year from the first day of March, 1899, to the first day of May, 1925, and for each and every fiscal year therafter (i.e., from May 1, 1925), payable in preference and priority to any payment of any dividend on the Common Stock for such fiscal year. * * *

"The Common Stock shall be subject to the prior rights of the holders of the Preferred Stock as herein declared. If after providing for the payment of full dividends for any fiscal year on the Preferred Stock there shall remain any surplus net profits of such year, any and all such surplus net profits of such year and of any other fiscal year after the full dividends shall have been paid on the Preferred Stock, shall be applicable to such dividends upon the Common Stock as from time to time shall be declared by the Board of Directors, and out of any such surplus net profits, after the closing of any fiscal year, the Board of Directors may pay such dividends upon the Common Stock of the corporation for such fiscal year, but not until the dividends upon the Preferred Stock for such fiscal year shall have been actually paid or provided and set apart. * * *"

Seven per cent. dividends were paid on the preferred stock to and including July 1, 1932. Since that time the following dividends on the preferred stock have been paid or declared:

4%—paid April 20, 1937, out of surplus net profits for 1937.
2½%—paid April 23, 1938, out of surplus net profits for 1938.
1¾%—paid on April 19, 1941, representing 19¢ per share of surplus net profits for 1937, and 10¢ per share out of the surplus net profits for 1938, and $1.46 per share out of the surplus net profits for 1941.
1¾%—paid July 7, 1941, out of the surplus net profits for 1941.
2.04%—declared July 7, 1941, out of the surplus net profits for 1941, payable August 29, 1941.
1¾%—declared July 10, 1941, out of the surplus net profits for 1941, payable October 1, 1941.

The directors of the defendant apparently intended to exhaust the net earnings of the company for the years 1937 and 1938 by the payment of the dividends mentioned for those years. However, they underestimated the profits for those years and declared a dividend on the preferred stock of 29¢ a share for the year 1941 to cover the difference.

On July 10, 1941, the directors declared a dividend of $1 per share on the common stock, one-half of which was payable from its "Reserve for Dividends on the Common Capital Stock, to be paid when and as declared by the Board of Directors", and the other half from the surplus net profits accumulated prior to April 30, 1941, which remained after the payment of the 1941 preferred stock dividends.

Complainant alleges that the surplus net profits for the fiscal year 1936 were more than $3,500,000 or more than seven per cent. per share on the preferred stock. No dividend was either declared or paid for that year. It is alleged that the surplus net profits for the year 1938 were more than $1,125,000 which would be at the rate of at least $3.89 per share on the preferred stock. The total dividends declared for 1938 were $2.60 per share. Complainant, therefore, contends that since no dividends were paid on the preferred stock for the year 1936 and since only a part of the dividends were paid on the preferred stock for 1938 the directors of the defendant should be restrained from paying any dividends on the common stock from funds which are properly surplus net profits for either of said years.

Defendant, by its answer, alleges that there were no surplus net profits for the year 1936 and that the surplus net profits for the year 1938 did not exceed the dividends paid on the preferred stock for that year.

Therefore, the question to be determined is what were the surplus net profits for the years 1936 and 1938. Defendant contends that in determining the net profits for dividend purposes it may compute its earnings on a consolidated basis; that is that in addition to the earnings or losses of the parent company it may add or subtract the respective earnings or losses of the subsidiaries owned by it. On the other hand complainant contends that the earnings should be determined on a non-consolidated basis. To illustrate the earnings from the defendant and its subsidiaries, it appears that in 1936 the parent company had a deficit of $1,304,662.16. The dividends from subsidiaries

were $4,860,200. The earnings of subsidiaries were $722,146.72. This left the deficit of the consolidated earnings of the parent company and its subsidiaries of $582,515.44. For the year 1938, calculated on the same basis, the parent company and its subsidiaries had consolidated earnings of $753,407.44. It is, therefore, apparent that the consolidated earnings when the dividends from the subsidiary companies are not accounted for, is vastly different from the result which is reached when such dividends are considered a part of the net profits of the defendant company.

The defendant says that the dividends received from the subsidiaries, which it owns, do not constitute a profit to it because the parent company was not enriched thereby. Defendant says that the dividends paid to it by the subsidiaries for the years 1936 and 1938 exceeded the earnings of the subsidiaries for the years in which the dividends were declared and that they were paid out of earnings of previous years. The defendant bases its argument on a false premise. It contends that separate corporations wholly owned by a parent company and directed by it in law are and should be considered subdivisions or departments of the parent company. In other words, defendant contends that the parent company and the subsidiaries referred to compromise one unit or enterprise. To substantiate this contention, counsel cites several cases. The first case cited is that of the North Jersey Title Ins. Co. v. Commissioner, 3 Cir., 84 F.2d 898. In that case the court disregarded the separate corporate identities in order to avoid an injustice.

The next case is Rippel v. Kaplus, 124 N.J.Eq. 303, 1 A.2d 883, 884. In the Rippel case a subsidiary corporation opposed the confirmation of a sheriff's sale on the ground that it lacked financial resources to protect itself. This court disregarded the corporate identity and held that the parent company for its own purposes had prevented the subsidiary from raising funds to pay its debts and that, therefore, the petitioner was not a distressed debtor. Counsel quotes from the opinion in the above cases as follows:

"While one company's ownership of shares of the capital stock of another does not necessarily create an identity of corporate interests between the two, 'yet where such ownership of stock is resorted to not for the purposes of participating in the affairs of the corporation in which it is held in a manner normal and usual with stockholders, but for the purpose of making it a mere agent, or instrumentality or department of another company, the courts will look through the forms to the realities of the relation between the companies as if the corporate agency did not exist and will deal with them as the justice of the case may require.' United States v. Reading Co., 253 U.S. 26, 40 S.Ct. 425, 434, 64 L.Ed. 760. This rule has been followed in New Jersey. Ross v. Pennsylvania Railroad Co., 106 N.J.L. 536, 148 A. 741; Stockton v. Central Railroad Co., 50 N.J.Eq. 52, 73, 24 A. 964, 17 L.R.A. 97. Chancellor McGill, in the last case, regarded the rule as an application of the doctrine, 'Equity looks at the substance, not merely the outward form' * * * and he quoted Morawetz on Corporations, sec. 227: 'The statement that a corporation is an artificial entity, apart from its members is merely a description, in figurative language, of a corpora-

tion viewed as a collective body. A corporation is really an association of persons, and no judicial dictum or legislative enactment can alter this fact.' "

The opinion does not sustain the contention of the defendant. In the case of United States v. Reading Co., therein referred to, the court disregarded the separate identities in order to prevent the consummation of a monopoly. In the case of Stockton v. Central Railroad Co., also referred to in the Rippel opinion, the court disregarded the form in order to prevent a fraudulent attempt to circumvent a statutory restriction against monopoly. In the case of Ross v. Pennsylvania Railroad Co. [106 N.J.L. 536, 148 A. 742], the Court of Errors and Appeals said:

"We agree that ownership alone of capital stock in one corporation by another, does not create any relationship by reason of which the stockholding company would be liable for torts of the other * * *."

The case did not turn on the question of control by one corporation over another by reason of stock ownership. The situation in the case was that the word "Pennsylvania" was painted on the tender of an engine and the cars and the crew wore uniforms bearing the initials "P.R.R.". The question presented to the jury was whether the Pennsylvania Railroad Company or the West Jersey Railroad Company, the subsidiary, operated and controlled the train. The court said:

"Where a corporation holds stock of another, not for the purpose of participating in the affairs of the other corporation, in the normal and usual manner, but for the purpose of control, so that the subsidiary company may be used as a mere agency or instrumentality for the stockholding company, such company will be liable for injuries due to the negligence of the subsidiary, and the mere fact that an accident is caused by the negligence of persons in the employ of the subsidiary will not relieve the dominant company of responsibility." * * *

There is a real distinction between a corporation and its stockholders. The corporate identity will be disregarded in equity only when it is necessary to do so in order to prevent fraud, deception, evasion or injustice. In such an event "Equity regards the substance and not the form". This rule was laid down recently in the case of Schmid v. First Camden Nat. Bank & Trust Co., 130 N.J.Eq. 254, 22 A.2d 246. Defendant's contention that separate corporate identities of wholly owned subsidiaries must always be regarded as mere departments or divisions of the parent company, is not supported by the cases.

Defendant submitted affidavits of several certified public accountants to the effect that the only proper method of computing the earnings of the parent company and its subsidiaries is on a consolidated basis. Complainant, on the other hand, submitted affidavits of certified public accountants denying this contention. The fact is that the accounts of the parent company and those of the subsidiaries are kept separately. The consolidated account is made solely for the purpose of the annual report of the stockholders upon which the bases for the dividends are determined. Under such circumstances the defendant company must be considered a separate and distinct entity for the purpose of fixing dividends and the earnings and profits of the sub-

sidiary companies do not enure to the benefit of defendant's stockholders until dividends are actually declared by its subsidiaries.

Defendant's brief suggests that there may be laches or an estoppel present in the institution of this action. The contention is that defendant has for many years presented consolidated reports to its stockholders which have never been questioned. There is nothing in the record, however, which establishes that the same conditions existed in previous years as existed in the years 1936 and 1938. This contention therefore falls.

The resolution of July 10, 1941, declaring a dividend on the common stock, directed that one-half of the dividend be paid from the account entitled, "Reserve for Dividends on Common Capital Stock to be paid when and as directed by the Board of Directors". The account referred to in said resolution was set up about the year 1908. Various additions and deductions were made thereto and therefrom until in July, 1941, it amounted to approximately $3,000,000. Defendant contends that because this reserve was created from profits earned during years when full dividends were paid on the preferred stock, that the whole reserve is now available for payment of dividends on the common stock even though dividends on the preferred stock were not paid for the years 1936 and 1938. This reserve account was a mere bookkeeping entry which set up therein a portion of earned surplus and did not separate funds of the company from its general assets. The secretary of the defendant company, in his affidavit, states that, "* * * the reserve above set out is in reality a part of the earned surplus, having been reserved out of the surplus net profits, although not treated as such on the respective balance sheets".

Defendant admits that where non-cumulative preferred stock has not been allotted the full dividend to which it is entitled in any one year and the corporation for that year has earned more than the dividend paid to the preferred stockholders, the preferred stock is entitled to have allotted to it such withheld earnings to the extent of its priority before dividends are paid to common stockholders. * * *

I, therefore, conclude that the restraint should be made permanent. The preferred stockholders are entitled to receive the surplus net profits for the years 1936 and 1938 not to exceed seven per cent. of the amount of the preferred stock before any dividends are paid on common stock from the reserve account to such extent, however, as the reserve is made up from the surplus net profits for the years 1936 and 1938. The surplus net profits for the year 1938, which consisted of the earnings of the defendant plus the dividends received from its subsidiaries, amount to over $1,125,000. Dividends of $2.60 on the preferred stock have been declared and paid based on the above surplus net profits. The rate, however, based on $1,125,000 would be at least $3.89 per share. Therefore, the common stock dividend voted last July should not be paid until the deficiency is provided for.

The same situation exists for the year 1936 for which year, however, there is a disagreement as to whether there was a profit or loss. The parent company shows a loss in its own operation before the receipt of dividends from its subsidiaries. It is claimed that part of the

dividend paid by the American Car and Foundry Securities Company (now known as the American Car and Foundry Investment Corporation) was represented by promissory notes of the American Car and Foundry Motors Company. Defendant claims that the notes are not worth their face value for the reason that the American Car and Foundry Motors Company was insolvent at the time it declared the dividend. The parent company, however, holds the notes the principal of which has not been paid although it has received interest thereon. There is not sufficient proof before me to determine the question.

I will refer this matter to a special master as suggested by the defendant for the purpose of determining the facts relative to same.[17a]

3. PARTICIPATING PREFERRED STOCK

LOCKWOOD v. GENERAL ABRASIVE COMPANY.

Supreme Court of New York, Appellate Division, Fourth Department, 1924
210 App.Div. 141, 205 N.Y.S. 511.

Appeal by defendant, General Abrasive Company, from a judgment by the Supreme Court in favor of plaintiffs, upon the decision of the court rendered after a trial at Erie Special Term.

CLARK, J. This action was brought for a declaratory judgment. (See Civil Practice Act, § 473; Rules Civil Practice rule 210 et seq.) The controversy is between the common and preferred stockholders of the General Abrasive Company, a domestic corporation.

The certificate of incorporation of the company is the contract between the two classes of stockholders, and their rights must be determined by the language of that instrument. Roberts v. Roberts-Wicks Co., 184 N.Y. 257, 77 N.E. 13, 3 L.R.A.,N.S., 1034, 112 Am.St. Rep. 607, 6 Ann.Cas. 213.

The real question to be determined here is: Are the common stockholders entitled to cumulative dividends? If they are, the authority to pay them must be found in the certificate of incorporation.

We may not read into that instrument words which it does not contain.

The dispute here is over the distribution of dividends. The defendant company proposes to distribute its surplus profits for the year 1923 by paying a seven per cent. dividend to owners of preferred stock and seven per cent. to owners of the common stock, and the remainder, if any, between the owners of the two classes of stock, in the ratio of their respective shares.

Plaintiffs contend that the provisions of the certificate of incorporation will not permit distribution of surplus earnings in this way. They contend that seven per cent. should be paid on the preferred stock and seven per cent. on the common stock and the remainder of the surplus to be applied in payments of dividends in arrears on the common stock, and after that is done the remainder, if any, to be distributed ratably between the holders of the preferred stock and the holders of the common stock.

[17a] Aff'd, 132 N.J.Eq. 460, 28 A.2d 531, 1942.

Defendant claims that after seven per cent. has been paid to the owners of the preferred stock and a like amount to the owners of the common stock, the remainder of the surplus should be divided pro rata between the holders of the preferred and the holders of the common stock, without first paying to the owners of the common stock amounts that would have been paid in former years if the surplus earnings in those years had justified it.

The learned court below was of the opinion that after the payment of seven dollars per share on the preferred stock, and seven dollars per share on the common stock, the common stockholders were next entitled to a payment of thirty-one per cent. on their shares to make up for dividends not earned or paid in former years, and that the surplus, if any, should be divided equally between the preferred and common shareholders.

I think the learned court adopted an erroneous construction of the certificate of incorporation with reference to dividends.

The clauses of the certificate of incorporation affecting the right of stockholders to dividends are as follows:

"Fourth. Dividends upon the preferred stock of the company at the rate of seven per centum (7%) per annum, cumulative after July first, one thousand nine hundred and sixteen, may be declared and paid out of the surplus profits, and no dividend in excess thereof shall be declared upon said preferred stock until dividends at the rate of seven dollars ($7.00) per annum shall have been declared and paid upon each share of the common stock.

"Whenever, after the declaration or payment of all accumulated dividends upon the preferred stock, any surplus profits shall remain, the same may be paid in dividends declared upon the common stock of the company up to the amount at the rate of seven dollars ($7.00) per annum upon each share of the common stock. Any surplus profits over and above said cumulative dividends upon preferred stock, and seven dollars ($7.00) per share per annum upon the common stock, may be paid in dividends in equal amounts upon each share of preferred stock and upon each share of common stock of the company."

It will be noticed that the certificate expressly provides that dividends upon the preferred stock shall be cumulative after July 1, 1916.

There is nothing in the certificate which says that the common stock shall be entitled to cumulative dividends, and inasmuch as the certificate is the contract between the shareholders, it must be presumed that it represented what they intended at the time of its execution, and we may not read into the instrument words which were not used and evidently not intended to be used when the certificate was made and executed.

The words of the certificate must be given their usual and ordinary meaning, and when it says that owners of common stock, after the declaration or payment of all accumulated dividends upon the preferred stock, may be paid dividends on common stock at the rate of seven per cent. per annum, it meant that they were to be paid such dividends yearly, or by the year, dividends that were earned and paid in any particular year, but that they could not out of a present surplus

be paid dividends for former years which had never been declared or earned.

A cumulative dividend is one "With regard to which it is agreed that if at any time it is not paid in full the difference shall be added to the following payment." Cent.Dict. "A dividend * * * which is not paid or received when due is added to what is to be paid in the future." Webster Internat.Dict. The idea being that arrearages of one year are payable out of the surplus earnings for subsequent years.

No such dividend distribution was contemplated by the certificate of incorporation in the instant case. If it had been the intention of the incorporators that the owners of common stock should be entitled to cumulative dividends it is fair to assume that they would have provided for such payments in so many words in the certificate of incorporation, as they did with reference to cumulative dividends for the preferred shareholders. If there were not profits to be divided in any year after making payments to preferred stockholders in accordance with the terms of the certificate of incorporation, they were lost forever, for each new year would mark the beginning of a new dividend period. Englander v. Osborne, 261 Pa. 366, 104 A. 614, 6 A.L.R. 800. Michael v. Cayey-Caguas Tobacco Co., 190 App.Div. 618, 180 N.Y.S. 532.

There is no justification for holding that the owners of the common stock are entitled to go back of the current year and claim to be reimbursed for unearned dividends of former years. To do so would make dividends cumulative in behalf of the owners of the common stock, and that was not expressed or contemplated by the certificate of incorporation.

In the absence of an agreement, expressed or implied, that dividends shall be cumulative, unpaid dividends in the past cannot be claimed. 10 Cyc. 573; 14 C.J. 421.[18]

Since the incorporation of defendant company in 1916 the preferred stockholders have received dividends amounting to forty-five and one-half per cent. That would be seven per cent. per annum. The common stockholders have received dividends amounting to fourteen and one-half per cent. The reason that the holders of the common stock did not receive larger returns in years gone by is because the dividends were not earned and declared.

If the certificate of incorporation had provided in terms that they were to receive cumulative dividends, as it did in the case of the owners of preferred stock, plaintiffs' position here would be unassailable, but in the absence of such provision in the certificate, to say that the owners of common stock are entitled to cumulative dividends, is to put a construction upon the certificates which, to my mind, would be unjustified.

The owners of the common stock, after provision was made for payment of dividends to the owners of the preferred stock, were entitled to seven per cent. per annum if it was earned in any one year, but I can see no justification in the language of the certificate itself for holding that out of the surplus earnings of 1923 the common stock-

18 To the effect that preferred stock is cumulative if not otherwise specified, see, 1938, 36 Mich.L.Rev. 1384.

holders have a preferential right to be paid dividends not earned and declared in former years so as to make their dividend payments since the organization of the company correspond with the payments that have been made to preferred stockholders. To adopt plaintiffs' theory would be to make the owners of common stock actually preferred stockholders, and that was not within the contemplation of the parties who organized the company.

The judgment should be modified by providing that any dividends in excess of cumulative dividends of seven per cent. upon the preferred stock of the defendant company, and seven percent. per share upon the common stock of defendant in any year shall be paid in equal amounts upon each share of preferred and common stock and as so modified the judgment should be affirmed, without costs of this appeal to either party.

The first conclusion of law is disapproved and reversed.

HUBBS, P. J., and DAVIS, J., concur; SEARS and CROUCH, JJ., dissent and vote for affirmance.

Judgment modified * * * any dividend in excess of cumulative dividends of 7% upon the preferred stock of defendant company, and 7% per share upon the common stock of defendant in any year shall be paid in equal amounts upon each share of preferred and common stock, and as so modified, judgment affirmed.[19]

McGAHAN v. UNITED ENGINEERING CORPORATION, Incorporated.

Court of Chancery of New Jersey, 1935. 118 N.J.Eq. 410, 180 A. 195.

Bill by George B. McGahan against the United Engineering Corporation, Incorporated.

Decree in accordance with opinion.

BUCHANAN, VICE CHANCELLOR. The defendant is a manufacturing corporation organized under the General Corporation Act of this state, in 1926 (2 Comp.St.1910, p. 1595, et seq., § 1 et seq., as amended). Its original certificate of incorporation provided for a capital stock of $125,000, divided into 25,000 shares of the par value of $5 each. By an amendment in 1928 its capital stock was increased to $500,000. The amendment (paragraph fourth) reads as follows: "Fourth. The total authorized capital stock of this corporation is Five Hundred Thousand ($500,000.) Dollars divided into Sixty-two Thousand Five Hundred (62,500) shares and the shares of this corporation are divided into two distinct classes of stock as follows: Twenty-five Thousand (25,000) shares of voting Class 'A' fully participating stock at Five ($5.00) Dollars per share, and Thirty-seven Thousand Five Hundred (37,500) shares Class 'A' non-voting fully participating stock at Ten ($10.00) Dollars per share."

Subsequently defendant sold and issued 21,700 shares of the class A nonvoting stock, for the par value of $217,000. In July, 1934, there

19 Aff'd without opinion, 240 N.Y. 592, 148 N.E. 719, 1925.

were issued and outstanding 22,600 shares of the class A voting stock and 21,700 of the class A nonvoting stock (both classes, for some reason, were designated "class A").

At that time the board of directors adopted a resolution to further amend paragraph fourth of the certificate of incorporation, and subsequently filed a certificate of such amendment; which amendment made paragraph fourth read as follows: "4th. The total authorized capital stock of this corporation is Five Hundred Thousand Dollars, ($500,000.), consisting of one hundred thousand shares, and the shares of this corporation shall be divided into two distinct classes, as follows: twenty-five thousand shares of voting Class 'A' fully participating stock at par value of Five Dollars ($5.00) per share, and seventy-five thousand shares of stock non-voting Class 'A' fully participating shares of stock at the par value of Five Dollars ($5.00) per share. The present stockholders of record shall be given the right to exchange their present holdings of Class 'A' fully participating non-voting stock, share for share, for the new class fully participating Class 'A' non-voting stock."

Thereafter the defendant company took $108,500 from the capital stock account of the nonvoting stock and transferred it to the capital surplus account of the company; notified the holders of the nonvoting stock that it was "necessary" for them to surrender their certificates of $10 par stock and receive instead an equal number of shares of $5 par stock; and declared a dividend of 25 cents per share on all the stock—valuing the nonvoting stock at $5 per share, the same as the voting stock.

Complainant, the holder of 185 shares of the nonvoting stock, thereupon filed his bill of complaint herein, setting forth the foregoing facts, and also the further facts that no publication was made, as required by the statute, of the reduction of capital stock, and that no vote was had, nor any opportunity to vote, by the holders of the nonvoting stock, on the proposed reduction. The bill charges that the attempted reduction of the nonvoting stock to the par value of $5 per share is unlawful and void; that it is a wrongful taking of property and rights from the holders of the nonvoting stock; and that the declaration and payment of a dividend of an equal amount per share to the voting stock ($5 par) and the nonvoting stock ($10 par) wrongfully deprives the holders of the nonvoting stock of the share in the earnings to which they are entitled.

The bill prays that the aforesaid acts of the defendant be set aside as null and void, and that the defendant be restrained from reducing its capital stock in that manner and from paying any dividend other than on the basis that the amount payable on each share of the nonvoting ($10 par) stock shall be twice as much as that payable on each share of the voting ($5 par) stock. * * *

The contention of defendant is that "shares are shares," so to speak; that all shares must be equal if there is no specific provision making them of unequal value, and that the provisions as to the par value in the two respective classes does not make the shares in the two classes unequal; that the actual capital of a corporation is not the aggregate

of the number of shares multiplied by the par value, but may be more or less—instancing corporations with shares of "no par value."

The answer to that contention is that we are not dealing here with a corporation whose certificate provides for shares of no par value, and this case must be determined by its own particular facts and circumstances. Where corporations have stock of "no par value," that stock is common stock, and the shares of that common stock are of course all of equal value; but the preferred stock is dealt with separately, and the value and priority of payment in respect thereof, both as to dividends and distributive value on dissolution, are specifically provided for.

In the instant case, the certificate of incorporation does not say that the shares are all to be of equal value. It says "the capital stock shall be $500,000 divided into 62,500 shares," and immediately goes on to say that those shares shall be divided into two distinct classes, "25,000 shares at $5.00 per share and 37,500 shares at $10.00 per share." From this it would seem to follow as a natural, if not indeed a necessary, inference that the entire 62,500 were *not* intended to be all of equal value, but that 37,500 of them were intended to be each of a value twice as great as that of each of the other 25,000 shares. No other conceivable explanation occurs, consonant with the fixing of the price of the nonvoting shares twice as great as that of the voting shares. (If the price had been fixed conversely, $10 for the voting shares and $5 for the nonvoting shares, defendant's argument would be much more rationally acceptable.) * * *

Clearly then there is nothing to prevent or prohibit a corporation from dividing its capital stock into divisions or shares which are not all equal each to the other—from dividing it into shares some of which have rights or interests in the net assets and in the earnings twice as great as the rights or interests of the remaining shares.

As has already been shown, this corporation did, by its certificate of incorporation (amendment of 1928), divide its stock into two classes; one class consisting of 25,000 shares, of the par value of $5 each and having voting rights; and the other class consisting of 37,500 shares, of the par value of $10 each, but having no voting rights. The aggregate shares in these two classes totals 62,500, which is the total specified authorized number of shares; and the aggregate par value thereof, at the *respective* par value rates, totals the total, specified, authorized capital. The 25,000 shares at $5 each aggregate $125,000, which is 1/4 of the total capital of $500,000; and the 37,500 shares at $10 each aggregate $375,000, which is the other 3/4 of the total capital. The result is that each $5 share represents a fraction or interest of 1/25000 of 1/4, or 1/100000, of the total capital or net assets; and each $10 share represents a fraction or interest of 1/37500 of 3/4 or 1/50000, or 2/100000, of the total capital or net assets.

In other words, one-quarter ($125,000) of the total capital has been divided into 25,000 shares, each of which is therefore 1/100000 of the total capital; and the remaining three-quarters ($375,000) of the total capital has been divided into 37,500 shares each of which is therefore 2/100000 or 1/50000 of the total capital. And these respective

shares or fractional interests in the *authorized* capital stock must needs continue to be the same thereafter, in the actual capital or net assets of the corporation, as that may vary from time to time by way of increase or decrease.

Now with respect to the profits earned upon the capital stock, and distributed in dividends, there is no dispute between the present parties as to the principle that there can be no discrimination between stockholders. All stockholders—at least all in the same class—must be treated alike; each stockholder is entitled to share in the dividend in proportion to the amount of his holdings. 14 C.J. p. 813, par. 1236; p. 817, par. 1240.

Defendant, however, says that this principle means that each stockholder must share in the dividend in proportion to the number of shares of stock held by him, irrespective of the difference in the fractional interest in the capital stock of the corporation represented by one share as compared with another, and regardless of the fact that the certificate of incorporation contains no such provision. With that contention this court cannot agree.

If this corporation had only one class of stock, or if all of its stock were divided into shares each of which represented the same fractional interest in the capital as each of the others, and there was no provision in the certificate of incorporation entitling a share in one class to a different amount of the profits or dividend than that of a share in the other class, then each stockholder would be entitled to dividends in proportion to the number of shares held by him.

This corporation, however, has divided its capital into shares of two different classes, and in the one class (the nonvoting stock), each share represents a fractional interest in the capital twice as great as the interest represented by each share of the other class (the voting stock).

It would have been possible, and legal, for the corporation to have provided in its certificate of incorporation that each share *in both classes alike* should share equally with each other share, regardless of its class, in any distribution of profits or dividends. This, however, it did not do, either specifically or by implication. The presumption, or conclusion, must be, therefore, that each share is entitled to share equally with all other shares, in the profits or dividends, *in proportion* to the fractional interests in the capital represented by the respective shares—and this on the principle that equality is equity.

Section 47 of the statute (2 Comp.St.1910, p. 1629, § 47) requires each corporation (in the absence of provision to the contrary in the certificate of incorporation) to declare and pay to and among its stockholders in January of each year "a dividend * * * of the whole of its accumulated profits" (over and above such sum as may have been fixed and set aside as working capital). Neither in this section, nor in any other provision of the statute, is there expressly set forth the method of computation of such dividend.

All surplus assets or accumulated profits, however, are obviously, prior to the setting apart or declaration of a dividend, simply a part of the capital assets or principal of the corporation. As has already

been said, the respective share or fractional interest (of the holder of any particular share of stock), in the total, net, corporate capital assets remains the same whether those net assets increase or decrease. The fractional interest in the profits, prior to declaration of a dividend, to which the holder of a share of stock is entitled, is therefore the same fraction as his fractional interest in the original capital stock. Clearly that fraction is not changed by the mere declaration of a dividend; there being no provision in the certificate of incorporation, nor in the statute, for any such change.

Quite the contrary is the implication to be gathered from section 86 of the statute (2 Comp.St.1910, p. 1652, § 86). That section provides that in a distribution of the assets of an insolvent corporation—i. e., a corporation which has lost money instead of making profits—the surplus funds, after payment of the corporation's creditors (and preferred stockholders, if any), shall be divided among the stockholders "proportionally, according to their respective shares." This latter must, of course, mean "in proportion to the respective fractional interests owned by them in the corporation's capital." The result is that each share of stock bears the same fraction of the total losses of the company as the fraction of the total capital of the company which it originally represented.

If the losses are to be borne in this proportion, then equitably the profits should be shared in like manner; there being no provision otherwise either in the statute or the certificate of incorporation.

The presumption must be, in the absence of any other agreement or legal requirement, that the stockholders will be entitled to share in the profits in proportion to the amounts respectively contributed by them to the capital. If, in the present instance, the entire corporate capital of $500,000 had been divided into only three shares, one of $250,000 and the other two of $125,000 each, the result might perhaps be a little more readily apparent, but the principle would be exactly the same.

It is concluded therefore that the dividend declared in 1934, if it is to be paid at all, must be adjusted so as to provide for payment of dividends on the respective shares in proportion to the respective fractional interest of the capital represented by the respective shares, for the payment of an amount on each share of nonvoting stock twice as great as the amount payable on each share of voting stock; and defendant will be enjoined from the payment of any dividend on any other basis.

The expression above, "if it is to be paid at all," is occasioned by the fact that it seems to appear on the record that this dividend was declared out of the surplus created by the illegal reduction of the value of the non-voting shares. If there is no other surplus out of which this dividend can be paid, obviously it cannot legally be paid at all. Moreover, it may be that in the judgment of the directors, no dividend should be paid at this time, in view of the setting aside of this "surplus" and the resultant condition of the corporation as to surplus and undivided profits. It would seem that the decree probably should be framed only to restrain the payment of dividends on any other basis than that herein adjudicated.

(a) *Liquidation Rights Conferred by Preferred Stock Contracts*

CONTINENTAL INSURANCE COMPANY v. UNITED STATES OF AMERICA.

Supreme Court of the United States, 1922.
259 U.S. 156, 42 S.Ct. 540, 66 L.Ed. 871.

[Facts: The Reading Co. was a holding company owning the entire capital stock of the Reading Railway Co., and $20,000,000 of its bonds, the entire capital stock of the Reading Coal Co., a majority of stock in the New Jersey Railroad Company.

[The United States sued to dissolve the relation existing between the Reading Co., and its subsidiaries, as a combination to restrain interstate commerce in anthracite coal, and as a violation of the Commodities Clause of the Act of 1906, c. 3591, 34 Stat. 585.[20]

[The decree of the court, provided that the stockholders of the Reading Co. should be furnished, at a cost of $2 each, certificates of interest, in the new Coal Co., to be formed by the court's order, to take over the property and business of the Reading Coal Co. Stockholders were required to sell, either these certificates of interest, or their stock in the Reading Co.

[The appeals in this case were taken by the Insurance Companies, who own 8,400 shares of the common stock of the Reading Company, less than one per cent. of the entire common stock, and by the so-called Prosser Committee, also interveners, who represent 407,728 shares of the common stock, which is somewhat less than 30 per cent. of the total common stock, and less than 15 per cent. of the entire capital stock of the company. Their appeals are based on the claim that the right to subscribe for the certificates of interest in the stock of the new Coal Company belong to the common stockholders of the Reading Company and to them alone, to the exclusion of the preferred stockholders.]

MR. CHIEF JUSTICE TAFT delivered the opinion of the court: * * *

We come now to the issue upon which these appeals were brought here. It concerns the respective rights of the common stockholders and the preferred stockholders in the assets of the Reading Company. They all, under the plan, will receive the benefit of the difference between the real value of the privilege of disposing of their distributive certificates of interest in stock in the new Coal Company, and the payment of $2, or such other sum as may be fixed, per share held by them of the Reading Company stock. Such difference has already been the subject of sale and quotation on the market in New York, and has varied from $11 to $20. This might have been expected, in view of the disparity between par of the capital stock of the Reading Coal Company and the far greater actual value of its properties. The disparity shows that while the transfer of certificates of interest in the new Coal Company stock is denominated a sale, it is only a distri-

[20] See, supra, f. n. 18, p. 457.

bution of the surplus or assets of the Reading Company to its stockholders, made necessary by the decree of this court in taking the Reading Company out of the coal business and restricting it to that of owning and operating a railroad system. The Reading Company, by merger with the Reading Railway Company, is made to change its character. Under the plan it must comply with the Act of Pennsylvania May 3, 1909, P.L. 408, 15 P.S. § 421 et seq., by which, in merging with the Reading Railway Company, it becomes a new corporation. Pennsylvania Utilities Co. v. Public Service Commission, 69 Pa. Super.Ct. 612; Lauman v. Lebanon Valley R. Co., 30 Pa. 42, 45, 72 Am.Dec. 685; Clearwater v. Meredith (Ferguson v. Meredith), 1 Wall. 25, 17 L.Ed. 604; Atlantic & G. R. Co. v. Georgia, 98 U.S. 359, 25 L.Ed. 185; Yazoo & M. Valley R. Co. v. Adams, 180 U.S. 1, 21 S.Ct. 240, 45 L.Ed. 395; Shields v. Ohio, 95 U.S. 319, 24 L.Ed. 357.

What is to be done is, in fact and law, a liquidation of the assets of the old Reading Company. Its stockholders receive their distribution in kind by retention of the stock they held in the old Reading Company as stock in the reduced new Reading Company, purged of its offense against the law, together with the distributive values of that which the old Reading Company has been compelled to get rid of; i. e., the ownership of the stock of the Coal Company. The distribution of certificates of interest in the new Coal Company shares was evidently given the form of a sale to enable the new Reading Company to realize out of it $5,600,000 in cash, to give it additional working capital enough properly to operate the Reading Railway System. But this does not change its real nature as a mere distribution of forbidden assets in kind to stockholders.

The rights of the common and preferred stockholders of the Reading Company inter sese are to be determined by the organization agreement of 1896. At that time, under a special charter of a corporation known as the Excelsior Enterprise Company, granted by the Pennsylvania legislature in 1871, the Reading Company, by change of name, came into being. The capital stock was increased to $140,000,000, divided into 2,800,000 shares of the par value of $50 each. Half of these were preferred, $28,000,000 first preferred, and $42,000,000 second preferred. The other half, or $70,000,000, were common, and the rights of the preferred and common stock were fixed by agreement. Each share of stock, whether common or preferred, had a vote. The agreement provided that the preferred stock should be entitled to noncumulative dividends "at the rate of, but not exceeding, 4 per cent. per annum, in each and every fiscal year, in preference and priority to any payment in or for such fiscal year, of any dividend on other stock; but only from undivided net profits of the company when and as determined by the board of directors, and only if and when the board shall declare dividends therefrom. If, after providing for the payment of full dividends for any fiscal year on the first preferred stock, there shall remain any surplus undivided net profits, the board, out of such surplus, may declare and pay dividends for such year upon the second preferred stock. If, from the business

of any particular fiscal year, excluding undivided net profits remaining from previous years, after providing out of the net profits of such particular fiscal year for the payment of the full dividends for such fiscal year on the first and second preferred stock, there shall remain surplus net profits, the board of directors may declare, and out of such surplus net profits of such year may pay, dividends upon any other stock of the company. But no dividends shall in any year be paid upon any such other stock out of net profits of any previous fiscal year in which the full dividends shall not have been paid on the first and second preferred stock."

The company was given the right at any time to redeem either or both classes of its preferred stock at par in cash, if such redemption should then be allowed by law, and after payment of dividends of 4 per cent. for two successive years on the first preferred stock, to convert the second preferred stock, not exceeding $42,000,000, par value, one-half into first preferred stock, and one-half into common stock, and to increase its first preferred and common stock to the extent necessary to effect such conversion. The company never exercised the right to convert or redeem the preferred stock.

It will be observed that the preferred stock and the common stock, with 1,400,000 shares of each, were thus given an equality of voting power which could not be changed without the consent of the company, and that it has not been changed, either by conversion or redemption. This would seem to have been designed to preserve an equilibrium of control in which reasonable dividends out of profits, when they accrued in sufficient amount, would be voted to the common stockholders, on the one hand, and proper additions would be made out of earnings to the capital of the company to increase its future profit-earning capacity and create a greater security for a constant payment of dividends to preferred stockholders. Of course, there would not be block voting of the two classes of stock, but the division did tend to secure a fair representation of both interests in the board of directors.

The effect of the agreement as to dividends upon the preferred and common stock seems to us clear. It emphasizes that dividends are to be paid only out of undivided profits, and when and as determined by the board of directors, and only if and when the board shall declare them. It leaves to the board to determine, in its discretion, whether the undivided profits shall be put in surplus working capital or in dividends. The limitations on the discretion of the board are that the first and second preferred cannot receive more than 4 per cent. in any fiscal year, and that neither the second preferred nor the common stock can receive any dividend until the first preferred dividend has been paid in full each year, and the common stock receives nothing until the second preferred dividend is thus paid. The words describing the condition upon which the power of the board to declare dividends on the common stock can be exercised show that each year's profits are to be considered by themselves in the distribution of dividends between the stock.

Appellants, however, rely on the final words of the clause to show that it is intended that net profits in any past year can be thereafter allowed to the common stock if, in that past year, the preferred stock had been paid full dividends. We do not find it necessary to decide that the board of directors has not such power; but, if so, the power is not one the exercise of which can be compelled in the absence of fraud or breach of trust. The failure of the board to exercise it, and the application of the earnings to surplus, determine such earnings to be assets as of the time of the compulsory winding up and liquidation of the corporation. The power to declare dividends not exercised can have no more effect upon the rights of the preferred stockholders to share in the existing assets of the corporation when liquidated than the failure of the company to convert preferred stock into common, or to redeem the preferred stock at par. The proper interpretation of the agreement is that, after the declaration of dividends for any current year, the undivided earnings are to be regarded as capital assets, and to be distributed on liquidation, unless the board of directors has meantime applied them as dividends. If the argument of appellants were carried to its logical result, all the net earnings of the Reading Company in twenty years, no matter how invested or applied to increasing the earning capital, must, in a liquidation, be treated as undistributed profits, to go entirely to the common stock without any action of the board of directors. This is impossible.

The record discloses that in 1904, when the Reading Company made its application to the New York Stock Exchange to have its stock listed, it contained the following statement:

"The preferred and common stock have equal voting power, and, in liquidation or dissolution of the corporation, will share equally in pro rata distribution of assets."

Coming, as this must have come, from the representatives of both the preferred and common stockholders, it is significant evidence of what they then thought of their respective rights, and has the additional weight of a representation to future purchasers of the two classes of stock as to the kind of interests they were buying in the company.

Our conclusion that the claim on behalf of the common stockholders is invalid is based on the construction of the words of the agreement itself, and hardly needs authority to sustain it. It is, however, in accord with the general common-law rule that stockholders, common and preferred, share alike in the assets of a liquidating corporation, if the preference is only as to dividends. * * * This is the rule in Pennsylvania. North American Min. Co. v. Clarke, 40 Pa. 432. The cases in which a different conclusion has been reached are where the contract or law determining the rights of the preferred stockholders has an express or clearly implied restriction as to the share which they may take in the assets on liquidation. Niles v. Ludlow Valve Mfg. Co., D.C., 196 F. 994; Russell v. American Gas & Electric Co., 152 App.Div. 136, 136 N.Y.S. 602.

The decree of the District Court is affirmed, with modifications al-

ready indicated, and the case is remanded for further proceedings in conformity to this opinion.[21]

OTIS & CO. v. SECURITIES AND EXCHANGE COMMISSION.

Supreme Court of the United States, 1945. 323 U.S. 624, 65 S.Ct. 483.

Proceeding in the matter of the application of the Securities and Exchange Commission to enforce and carry out a plan for liquidation of the United Light & Power Company under the Public Utility Holding Company Act of 1935, 15 U.S.C.A. § 79 et seq., wherein Otis & Company, a preferred stockholder, intervened. To review a judgment of the Circuit Court of Appeals, 142 F.2d 411, which affirmed a judgment of the District Court, 51 F.Supp. 217, granting the application, Otis & Company brings certiorari.

Affirmed.

MR. JUSTICE REED delivered the opinion of the Court.

An important although narrow legal point in the interpretation of the Public Utility Holding Company Act of 1935 is involved in this case. This is whether a plan under section 11(e) of that act may be "fair and equitable" to preferred stockholders within the meaning of those words as used in that section, which allows a participation by junior common stockholders in the distribution of the assets of a registered holding company, which is liquidated in compliance with section 11(b) (2), before the senior preferred stockholders receive securities whose present value equals the preferred's full liquidation preferences.

The Securities and Exchange Commission approved the Plan, Holding Company Act Release No. 4215, April 5, 1943. The United States District Court of Delaware approved the Plan, D.C., 51 F. Supp. 217, and the Circuit Court of Appeals affirmed this action. This Court has jurisdiction under Judicial Code, Section 240, 28 U.S. C.A. § 347, and Section 25 of the Holding Company Act. Certiorari was granted because of the importance of the question raised in administration of the act. 322 U.S. 724, 64 S.Ct. 1289.

The United Light and Power Company, a Maryland corporation, is a registered holding company under the Act. Section 5. It is the top holding company of a large system with twenty-four other corporate associates. Section 2(a) (10). Its place in the system violates the prohibition of the Act against a registered holding company being a "holding company with respect to [any] of its subsidiary companies [Sec. 2(a) (8)] which itself has a subsidiary company which is a holding company." Section 11(b) (2). This prohibition is known as the "great-grandfather clause."

In proceedings for the simplification of the system, after finding that Power violated the great-grandfather clause, an order was entered on March 20, 1941, directing that Power be liquidated and

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21 See, Christ, Right of Holders of Preferred Stock to Participate in the Distribution of Profits, 1929, 27 Mich.L.Rev. 731; 1935, 33 Mich.L.Rev. 439.

dissolved. The order authorized Power to submit to the Commission a plan for compliance with the order "on a basis which is fair and equitable to its security holders." Power with its registered holding company subsidiary, The United Light and Railways Company, a Delaware corporation, all of whose common stock was owned by Power, submitted such a plan and after examination by the Commission and modification it was approved by order of April 5, 1943. The Plan was held specifically to be fair and equitable to all security holders. By the application and order Railways' participation in the Plan was accepted. Holding Company Act Release No. 4215. This is the order which is before us.

It approved the Plan for the liquidation and dissolution of Power as "necessary to effectuate the provisions of Section 11(b) of the" Act. It directed counsel for the Commission to apply to an appropriate federal court for an order enforcing the Plan. The central feature of the Plan and the one here in issue was Power's proposed distribution of its assets to its preferred and common stockholders. Power's chief asset was its holdings of common stock in its subsidiary, Railways. It represented over $72,000,000 of its total gross assets of a little more than $81,000,000. All other property of Power which remained after the satisfaction of its obligations was to be distributed by Power to Railways. Thus this residual property of Power would inure to the benefit of Railways' new common stockholders, the former stockholders of Power.

Distribution of Power's common stock holdings in Railways was to be effected on the basis of 5 shares of Railways' common stock for one share of Power's preferred and one share of Railways' common for 20 shares of Power's common, and allocation of 94.52% to Power's preferred stockholders and 5.48% to Power's common stockholders. As Railways was the only company in the tier below Power of the holding company system, it would become by the dissolution of Power the top holding company and Power's preferred and common stockholders, by the distribution to them of all of Railways' common, would have in the aggregate the same rights in Railways and in the holding company system that Power had. The rights and preferences of Power's stockholders would of course disappear with the distribution of Railways' common and the dissolution of Power. As holders of Railways' single class of common, a new relationship of equality would arise between Power's preferred and common stockholders.

This order was preceded by an examination by the Commission into the situation of this holding company system. For a clear understanding of the single issue as to whether, in the liquidation of a holding company by order of the Commission under section 11(e), a participation by junior security holders in the assets is permissible before preferred security holders have received the entire liquidating preference secured to them by the company's charter, it is sufficient to state only the following facts about which there is no controversy between the litigants. Power is a solvent company. As of April 30, 1942, and there is no intimation that its condition has worsened, its balance sheet showed assets of $81,159,075 and liabilities

of only $6,132,976, without consideration of its capital stock structure. Its principal asset, the Railways common stock heretofore referred to, has a book value in excess of the $72,000,000 plus at which it is carried on Power's balance sheet and an actual value which makes Power unquestionably solvent with large equity values in its stock.

Power has outstanding 600,000 shares of Class A Preferred. This preferred stock has a liquidation value of $100 per share or $60,000,000 plus arrearages of $38,700,000 as of December 31, 1942, or a total liquidating value ahead of the common, as of the time of the order of $98,700,000. There are 2,421,192 shares of Class A common and 1,055,576 shares of Class B common.

The Commission found the balance sheet value of all Railways' common on a pro forma corporate basis to be $77,954,874 and, when using a pro forma consolidated basis for the entire system, to be $81,554,330. On a capitalization of reasonably anticipated earnings of the system, the Commission was unable to find a value for Railways' common "which approaches $98,700,000.00."

If the liquidation preference of Power's preferred stock is applicable, under the Commission's conclusions on present valuations all of the Railways' common would go on distribution to Power's preferred. The Commission determined that the liquidation preference was not applicable and for these reasons.

The Commission's order of March 20, 1941, for the liquidation and dissolution of Power was a step in the simplification of the holding company system which simplification was enjoined by section 11(b) (2) of the Act. Satisfaction of the great-grandfather clause might have been obtained in this or other holding company systems by an order for merger, consolidation or recapitalization between top holding companies or between associate companies in the lower tiers of the corporate hierarchy. Such procedure would avoid the liquidation of Power. Cf. Windhurst v. Central Leather Co., 105 N.J.Eq. 621, 149 A. 36; Porges v. Vadsco Sales Corporation, Del.Ch., 32 A.2d 148, 151. The selection by the Commission of one method of system adjustment to accomplish simplification rather than another is an incident which ought not to affect rights. The exercise of legislative power by Congress through section 11(b) (2) to accomplish simplification as a matter of public policy and the Commission's administration of the Act by dissolution of this particular company results in a type of liquidation which is entirely distinct from the "liquidation of the corporation, whether voluntary or involuntary" envisaged by the charter provisions of Power for preferences to the senior stock.

This conclusion permitted the Commission to examine the investment values of the common and preferred stocks of Power. The rights of the preferred stock to $6 annual cumulative dividends in the going business and to full priority in liquidation other than by operation of the Act were treated as factors in valuation rather than determinative of amounts payable in a traditional dissolution. Upon analysis of the Holding Company System's experience and upon an

estimate of future earnings, the Commission assumed earnings of $6,185,000 annually which would be applicable to Railways' common and, as a consequence of the distribution, to Power's preferred and common stockholders. Since the annual preferred dividend requirements were $3,600,000, there appeared a balance of $2,585,000 available for the reduction of preferred stock arrearages of $38,700,000 as of December 31, 1942. The Commission noted that if all the assumed earnings materialized and were applied to liquidating the preferred current and deferred dividends, in approximately fifteen years the arrearages would be paid and the common would be in a position to receive dividends. Furthermore, only by forced liquidation could the common stock be deprived of its possibility for future earnings. Only by means of forced liquidation and the receipt of all Railways' common, could Power's preferred gain a right to prospecttive earnings above its guaranteed dividends. The deferred dividends do not bear interest. While recognizing that the common stock participation was remote, the Commission determined that in its "overall judgment" Power's common had a legitimate investment value of a proportion of 5.48 per cent of Power's assets to the preferred's value of 94.52 per cent. Such a conclusion is not "susceptible of mathematical demonstration," any more than any other valuation of a utility's worth. The Commission determined this allocation was fair and equitable within section 11(e).

Petitioner does not challenge the above allocation of values between the preferred and common stock of Power, if the Commission is correct in treating the stock rights as though in a continuing enterprise instead of in liquidation. Petitioner relies upon the charter rights which on liquidation of Power give to the preferred $100 and the cumulated and accrued dividends. * * * It relies upon the authorities of this and other courts which hold that under a full priority rule junior securities in bankruptcy or equity reorganizations may not participate in the assets until the rights of the holders of senior securities are satisfied in full. Petitioner says:

"When the Plan, whatever the device used, contemplates the surrender of outstanding securities for new securities, either in the same or a different company, it is not 'fair and equitable' to force senior security holders to accept less than that which they are contractually entitled to receive."

To petitioner, no distinction is to be drawn between liquidation under bankruptcy or reorganization and liquidation under the public Utility Holding Company Act by virtue of sections 11(b) (2) and 11(e).

We reach the conclusion that the Securities and Exchange Commission applied the correct rule of law as to the rights of the stockholders inter sese. That is to say, when the Commission proceeds in the simplification of a holding company system, the rights of stockholders of a solvent company which is ordered by the Commission to distribute its assets among its stockholders may be evaluated on the basis of a going business and not as though a liquidation were taking place.

The manifest solvency of Power simplifies the problem of stockholders' rights with which we are here concerned. The creditors are satisfied. No possibility exists that simplification of structure is employed here to evade or nullify creditors' rights in reorganization or to take the place of traditional reorganization.

Like the bankruptcy and reorganization statutes, the Public Utility Holding Company Act, in providing that plans for simplification be "fair and equitable," incorporates the principle of full priority in the treatment to be accorded various classes of security interests. This right to priority in assets which exists between creditors and stockholders, exists also between various classes of stockholders. When by contract as evidenced by charter provisions one class of stockholders is superior to another in its claim against earnings or assets that superior position must be recognized by courts or agencies which deal with the earnings or assets of such a company. Fairness and equity require this conclusion. Even before our decision in Case v. Los Angeles Lumber Products Co. on November 6, 1939 [308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110], recent federal cases had recognized this priority. That has been their view since the Case decision, In re Porto Rican American Tobacco Co., 2 Cir., 112 F.2d 655, 656, 657. This is the rule applied by the Commission in the simplification of corporate structure. The Commission recognizes and applies the doctrine of full priority by giving value to the rights of the preferred in a going concern rather than as if by sale and distribution. Its views are stated below. The issue in this case is not whether full priority should be given to preferred over common stockholders but whether the priority which is established by the charter, note 6, is applicable to a simplification by liquidation under § 11(b) (2) and (e). There is an argument that if the charter provision applies to this situation, it cannot be disregarded and that in such a liquidation "fair and equitable" would require the distribution of assets only to the preferred. We do not reach that question. The point at issue is whether this charter provision applies.

The applicability of the charter provision under the Public Utility Holding Company Act of 1935 is a matter of federal law. * * * It may be that if the charter liquidation preference were held to cover this situation it would not frustrate the simplification of the holding company system, to the same degree that the gold clause agreements interfered with the power of Congress to regulate the gold content of the dollar. Norman v. Baltimore & O. R. Co., 294 U.S. 240, 306, 55 S.Ct. 407, 415, 79 L.Ed. 885, 95 A.L.R. 1352, et seq., and cases cited. Distribution to preferred stockholders only with disregard of common's interest would eliminate Power and cure the system's present inconsistency with the great-grandfather clause. We think, however, the charter preference is inoperative in simplification under section 11(b) (2). The provision having been adopted in 1929, six years prior to enactment of the Public Utility Holding Company Act, a "simplification" under this Act, having as an incident to it the dissolution of one company in a holding company system, was not an anticipated "liquidation" within the meaning of Pow-

er's charter provision. Enforcement of an overriding public policy should not have its effect visited on one class with a corresponding windfall to another class of security holders. Nor should common stock values be made to depend on whether the Commission, in enforcing compliance with the Act, resorts to dissolution of a particular company in the holding company system, or resorts instead to the devices of merger or consolidation, which would not run afoul of a charter provision formulated years before adoption of the Act in question. The Commission in its enforcement of the policies of the Act should not be hampered in its determination of the proper type of holding company structure by considerations of avoidance of harsh effects on various stock interests which might result from enforcement of charter provisions of doubtful applicability to the procedures undertaken. While pre-existing contract provisions exist which produce results at variance with a legislative policy which was not forseeable at the time the contract was made, they cannot be permitted to operate. Compare New York Trust Co. v. Securities and Exchange Comm., 2 Cir., 131 F.2d 274; In re Laclede Gas Light Company, D.C., 57 F.Supp. 997. The reason does not lie in the fact that the business of Power continues in another form. That is true of bankruptcy and equity reorganization. It lies in the fact that Congress did not intend that its exercise of power to simplify should mature rights, created without regard to the possibility of simplification of system structure, which otherwise would only arise by voluntary action of stockholders or, involuntarily, through action of creditors. We must assume that Congress intended to exercise its power with the least possible harm to citizens. * * *

The Continental or Reading case turned, however, on the charter rights of the preferred to share equally with the common in earnings which had become assets, pages 179, 180 of 259 U.S., at pages 547, 548 of 42 S.Ct., 66 L.Ed. 871, not on whether a right to share was matured or varied by governmental action. Contrary to the situation in this present case, the charter provisions of the Reading Company were adopted with knowledge of the sanctions of the Sherman Act against monopoly. 259 U.S. at pages 171 and 177, 42 S.Ct. at pages 545, 547, 66 L.Ed. 871. We do not feel constrained by its dealing with charter rights as in a normal liquidation to hold that where liquidation is adopted as a matter of administrative routine, the preferences are thereby matured. * * *

Affirmed.

MR. JUSTICE DOUGLAS took no part in the consideration or decision of this case.

MR. CHIEF JUSTICE STONE, dissenting.

MR. JUSTICE ROBERTS, MR. JUSTICE FRANKFURTER and I think the judgment below should be reversed. * * *

Here Congress has commanded the Commission to respect contract rights by requiring that its action conform to the well defined meaning of the phrase "fair and equitable." Congress seems to have recognized that the stipulated priorities of stockholders were

not to be disturbed in liquidations ordered under the Public Utility Holding Company Act. The report of the Senate Committee (S.Rep. No. 621, 74th Cong., 1st Sess., p. 33) recommending the enactment of the present statute and proponents of the Bill (H.R.Rep. 1318, 74th Cong. 1st Sess., pp. 49-50; 79 Cong.Rec. 4607, 8432) repeatedly cited Continental Insurance Co. v. United States, supra, in which it was held that the distribution in a liquidation compelled by the enforcement of the Sherman and Hepburn Acts must preserve the stipulated priorities of the several classes of stockholders of the offending corporation.

The intimation that the priority stipulation can be disregarded in the present liquidation because the Commission could have effected the simplification of the holding company structure by merger, consolidation or recapitalization, is merely to say that such procedure would not involve liquidation, voluntary or involuntary, or, what comes to the same thing, that the preferred stockholders could not claim the protection of the priority stipulation in situations to which it does not and was not intended to apply. By buying preferred stock the preferred stockholders paid for the privilege of membership in the corporation and for participation in the fruits of the corporate enterprise, to continue, with full priority of dividends so long as the corporation should continue as a going concern. But in the event of liquidation they stipulated and paid for the specified priority over the common stockholders in the distribution of the net corporate assets. The preferred stockholders here assert only the rights to which that stock is entitled on liquidation by the terms of the priority stipulation. Calling the preferred stockholders' right of priority a "windfall" will not serve as an apology, explanation, or justification for the Commission's action in appropriating the priority of the preferred in order to give a windfall to the common. It is no answer to say that their claim on liquidation might have been avoided by not liquidating or to say, as the Commission has ordered, that they must accept on liquidation less than their stipulated priority on liquidation and less than the rights to which they would have been entitled if the corporation had continued as a going concern.

The judgment should be reversed.

SHANIK et al. v. EMPIRE POWER CORPORATION et al.
CLARK et al. v. SAME.

Supreme Court of New York, Special Term, 1945. 58 N.Y.S.2d 176.

Consolidated derivative suits by Alexander Shanik and another, as plaintiffs, suing on their own behalf and on behalf of all holders of participating stock of Empire Power Corporation, and by Kenneth F. Clark and another, etc., against the Empire Power Corporation, in dissolution, and others, to require restoration of excess distribution on dissolution to common stockholders.

Motions to dismiss denied, and plaintiffs held entitled to judgment, but judgment held in abeyance pending further hearing.

SCHREIBER, JUSTICE. Plaintiffs are the holders of 1400 shares of the Participating Stock of Empire Power Corporation. Pursuant to statute (Sec. 105, Stock Corporation Law), that corporation was dissolved in January 1945 and its assets distributed shortly thereafter. The complaint in this consolidated derivative suit charges that such distribution was in violation of the corporate charter, as amended, and improperly favored the Common Stock over the Participating Stock.

The Common Stock was the sole voting stock; 400,000 shares had been issued and were outstanding; all were held by defendant Eastern Seaboard Securities Corporation, thus in control of Empire. Of 400,000 shares of Participating Stock likewise issued, 175,585 were outstanding at the time of dissolution and of these Eastern held 140,471. An issue of preferred stock had been redeemed and retired long prior to dissolution.

Concededly, the amended charter provided preferential and cumulative dividends to the Participating Stock and permitted, if there were sufficient additional surplus, declaration of dividends to the Common Stock, as a class, to an amount equal to that received by the Participating shares as a class. Aggregate dividends to both classes were to be equal, measured by the dividends on the Participating Stock.

The scheme of the charter is clearly stated:

"There shall never be distributed in aggregate to the Common Stock, as a class, for any period of time, whether by dividends or otherwise, a greater sum than shall have theretofore, including the same period been paid to the Participating Stock as a class * * *."

Over the years the aggregate dividends to the Participating Stock as a class were greater than the aggregate dividends to the Common Stock as a class. At least before dissolution, it is clear that pursuant to the charter a compensating dividend to the Common Stock, as a class, might well have been declared, for the funds were at hand. Eastern, holding all of the voting or Common Stock of Empire, properly then might have brought about class equality between the two types of stock, by declaring a dividend to itself, as the sole common stockholder, of that differential of aggregate dividends between the two classes of stock.

This was not done but, as ruled on trial, the reason for the omission is immaterial to the question at bar, which is simply to construe the charter as a matter of law and to determine whether the formula for distribution of the assets on dissolution, prescribed therein, permits an equalizing adjustment thereon.

The clauses of the amended charter covering such distribution on dissolution, thus required to be examined, are:

"In any distribution of assets other than by dividends from surplus or profits, the Participating Stock shall have a preference over the Common Stock until there shall have been paid on each share of the Participating Stock Forty dollars ($40), plus the amount, if any, by which Two dollars and twenty-five cents ($2.25) per annum from the date after which dividends on said share became cumulative to the date of such distribution exceeds the preferential dividends (as dis-

tinguished from the participating dividends) actually paid thereon or declared and set apart for payment thereon."

"In any distribution of assets, other than by dividends from surplus or profits, the Common Stock then outstanding, as a class, in subordination to * * * the Participating Stock, shall be entitled to a sum equal to Forty dollars ($40) for each share of Participating Stock then outstanding, plus the amount, if any, by which Two Dollars and twenty-five cents ($2.25) per annum from the date after which dividends on said share of Participating Stock became cumulative to the date of such distribution exceeds the preferential dividends actually paid thereon or declared or set apart for payment; and said sum shall be paid and distributed to the holders of the Common Stock then outstanding pro rata, according to their respective holdings thereof."

"In any further distribution of assets, other than by dividends from surplus or profits, the assets so to be distributed shall be divided into two equal parts; and one of said parts shall be distributed pro rata among the holders of Participating Stock then outstanding according to their respective holdings thereof, and the other of said parts shall be distributed pro rata among the holders of Common Stock then outstanding according to their respective holdings thereof."

There is no dispute as to the application of the first of the foregoing clauses relating to distribution to the Participating Stock on dissolution and stating the amounts due that stock in the first instance on distribution; it is the construction of the succeeding clause giving a like formula as to the Common Stock that gives rise to this litigation.

Plaintiffs contend that the inescapable meaning of the language used is that, if assets are sufficient, on dissolution a sum measured by and equal to but in no event greater than that paid in the aggregate to the Participating stockholders as a class is to be paid to the Common stockholders as a class; and that, after both classes of stock are thus paid, any excess is to be divided equally between them in accordance with the charter provision last quoted. Thus, as the Common Stock as a class actually did receive on this distribution a sum in excess of that received by the Participating Stock as a class, plaintiffs seek a decree herein that the responsible defendants be required to restore to the corporation one-half of that excess distribution, or $4,032,965.96, to be redistributed to the Participating stockholders pro rata.

It is defendants' contention that the language is susceptible of an interpretation that will restore on distribution the class inequality suffered in dividends; that the scheme of the charter, read as a whole, of class equality between the two types of stock will then be preserved.

* * *

Thus on distribution on dissolution defendants sought to reach class equality between the two types of stock by additionally granting, to the extent that funds were sufficient, to the Common Stock the aggregate class dividend differential that arose during the existence of the corporation. That differential was $9,082,279.

Defendants make no suggestion that the differential was attempted to be made up by the declaration of a belated dividend in any sense; the claim is solely that its payment was proper and in entire conformity

with the distribution formula on dissolution with regard to the Common Stock.

Although the construction urged by plaintiffs is grammatically sound, the Court nevertheless may adopt another if the choice is fairly and reasonably open from the language employed and a true and equitable result obtained thereby. The difficulty with defendants' interpretation of the formula is that its application creates class inequality even as that of which they complain and for which there is utterly no support in the charter. The gross dividend differential is $9,082,279 and yet the computation made by defendant yields a differential of $11,792,000. This figure was in effect reduced in the final reckoning on distribution, but it is evident that a formula producing such a result affords the Court no proper basis for departure, by straining the language, from the plain meaning of the charter provision. Thus it will serve no useful purpose to consider at length other labored arguments advanced by defendants for the Court is constrained to hold that the charter provisions in question require that, on dissolution, the Common Stock as a class shall in no event receive more than the Participating Stock as a class.

True it is, as defendants urge, that the intent of the charter is class equality of dividend and a like equality on distribution. Admittedly there was class inequality in dividends. But dividends are incident to continued corporate existence and are payable out of surplus; distribution on dissolution is liquidation of the corporation and embraces all assets. Stock Corporation Law, §§ 11, 58, 105; [Citing cases.] * * *

The Court holds that it may not do violence to that contract by approving a distribution on dissolution in direct violation of the controlling charter provision, in order to counterbalance a deliberate failure seasonably to declare a dividend before dissolution under other, distinct and unrelated charter provisions.

It follows that the motions to dismiss the complaint are denied and that plaintiffs are entitled to judgment that the responsible defendants restore one-half the excess distribution on the Common Stock to be redistributed to the Participating stockholders pro rata. Interest will be allowed from the date of excess payment. The reserved motion to strike the testimony of William J. Wilckens is denied and all testimony relating to motivation for nondeclaration of the dividend in question to the Common Stock is stricken as immaterial, with appropriate exceptions.

This conclusion brings up defendants' plea that a decree be moulded consonant with the true equities presently existing. Defendant Eastern, as stated, holds a large percentage of Empire's Participating Stock. Said defendant has offered in evidence a consent by all its stockholders that any recovery herein be reduced to the extent that Eastern, as a Participating stockholder, may share therein. For the purpose of a proper and just decree the exhibits offered in this regard are held proper, are admitted in evidence and objections thereto are overruled, with appropriate exceptions. Ordinarily the recovery would be that of the corporation for whose benefit the suit was brought. Pollitz v. Wabash Railroad Co., 167 App.Div. 669, 685, 686, 152 N.Y.S.

803, 814, 815; Berger v. National Architects' Bronze Co., 173 App.Div. 680, 682, 160 N.Y.S. 331, 333. The Court in a proper case where special circumstances exist should adjust the decree to the realities of the situation and prevent unnecessary circuity and hardship. Harris v. Rogers, 190 App.Div. 208, 179 N.Y.S. 799; Kittinger v. Churchill, 161 Misc. 3, 292 N.Y.S. 35, affirmed 249 App.Div. 703, 292 N.Y.S. 51; Hayman v. Morris, Sup., 46 N.Y.S.2d 482, 495.

On the bare record in this regard, however, there is difficulty in determining what adjustments and allowances are proper and, indeed whether moulding the decree is feasible at all under the circumstances. The matter was hardly litigated. It is clear at least that fees, expenses and a number of other variants possibly affecting the net recovery should be considered and that Eastern is not necessarily entitled to a set-off based on the exact percentage of Participation Stock held. Further Eastern may be entitled to credits by reason of its assumption of contingent liabilities of Empire on dissolution; and in view of the fact that the excess distribution to the Common Stock (Eastern) was wholly or partly in kind, consisting of stock of other corporations, a problem arises as to the manner and form of restoration and as to accounting for dividends and profits thereof.

In the interest of justice the parties will be given an opportunity to be heard on all of the foregoing matters, and any others relevant thereto. Pending such further hearing, decision and judgment will be held in abeyance.[21a]

ZAHN v. TRANSAMERICA CORPORATION.

Circuit Court of Appeals of the United States, Third Circuit, 1947.

162 F.2d 36.

BIGGS, CIRCUIT JUDGE. ZAHN, a holder of Class A common stock of Axton-Fisher Tobacco Company, a corporation of Kentucky, sued Transamerica Corporation, a Delaware company, on his own behalf and on behalf of all stockholders similarly situated, in the District Court of the United States for the District of Delaware. His complaint as amended asserts that Transamerica caused Axton-Fisher to redeem its Class A stock at $80.80 per share on July 1, 1943, instead of permitting the Class A stockholders to participate in the assets on the liquidation of their company in June, 1944. He alleges in brief that if the Class A stockholders had been allowed to participate in the assets on liquidation of Axton-Fisher and had received their respective shares of the assets, he and the other Class A stockholders would have received $240 per share instead of $80.80. Zahn takes the position that he has two separate causes of action, one based on the Class A shares which were not turned back to the company for redemption; another based on the shares which were redeemed.[22] He prayed the court below to direct

21a Aff'd, 296 N.Y. 664, 69 N.E.2d 818, 1946.

22 The plaintiff was originally the holder of 235 shares of Class A stock purchased on four occasions between July 23 and August 10, 1943, inclusive. Between August

Transamerica to pay over to the shareholders who had not surrendered their stock the liquidation value and to pay over to those shareholders who had surrendered their stock the liquidation value less $80.80. Transamerica filed a motion to dismiss. The court below granted the motion holding that Zahn had failed to state a cause of action. See 63 F.Supp. 243. He appealed.

The facts follow as appear from the pleadings, which recite provisions of Axton-Fisher's charter. Prior to April 30, 1943, Axton-Fisher had authorized and outstanding three classes of stock, designated respectively as preferred stock, Class A stock and Class B stock. Each share of preferred stock had a par value of $100 and was entitled to cumulative dividends at the rate of $6 per annum and possessed a liquidation value of $105 plus accrued dividends. The Class A stock, specifically described in the charter as a "common" stock, was entitled to an annual cumulative dividend of $3.20 per share. The Class B stock was next entitled to receive an annual dividend of $1.60 per share. If further funds were made available by action of the board of directors by way of dividends, the Class A stock and the Class B stock were entitled to share equally therein. Upon liquidation of the company and the payment of the sums required by the preferred stock, the Class A stock was entitled to share with the Class B stock in the distribution of the remaining assets, but the Class A stock was entitled to receive twice as much per share as the Class B stock.[23]

Each share of Class A stock was convertible at the option of the shareholder into one share of Class B stock. All or any of the shares of Class A stock were callable by the corporation at any quarterly dividend date upon sixty days' notice to the shareholders, at $60 per share with accrued dividends.[24] The voting rights were vested in the Class B stock but if there were four successive defaults in the payment of quarterly dividends, the class or classes of stock as to which such defaults occurred gained voting rights equal share for share with the

2 and August 20, 1943, the plaintiff surrendered for redemption 215 shares and retained 20 shares.

23 The charter provides as follows:

"In the event of the dissolution, liquidation, merger or consolidation of the corporation, or sale of substantially all its assets, whether voluntary or involuntary, there shall be paid to the holders of the preferred stock then outstanding $105 per share, together with all unpaid accrued dividends thereon, before any sum shall be paid to or any assets distributed among the holders of the Class A common stock and/or the holders of the Class B common stock. After such payment to the holders of the preferred stock, and all unpaid accrued dividends on the Class A common stock shall have been paid, then all remaining assets and funds of the corporation shall be divided among and paid to the holders of the Class A common stock and to the holders of the Class B common stock in the ratio of 2 to 1; that is to say, there shall be paid upon each share of Class A common stock twice the amount paid upon each share of Class B common stock, in any such event."

24 The charter provides as follows:

"The whole or any part of the Class A common stock of the corporation, at the option of the Board of Directors, may be redeemed on any quarterly dividend payment date by paying therefor in cash Sixty dollars ($60.00) per share and all unpaid and accrued dividends thereon at the date fixed for such redemption, upon sending by mail to the registered holders of the Class A common stock at least sixty (60) days' notice of the exercise of such option. If at any time the Board of Directors shall determine to redeem less than the whole amount of Class A common stock then outstanding, the particular stock to be so redeemed shall be deter-

Class B stock. By reason of this provision the Class A stock had possessed equal voting rights with the Class B stock since on or about January 1, 1937.

On or about May 16, 1941, Transamerica purchased 80,160 shares of Axton-Fisher's Class B common stock. This was about 71.5% of the outstanding Class B stock and about 46.7% of the total voting stocks of Axton-Fisher. By August 15, 1942, Transamerica owned 5,332 shares of Class A stock and 82,610 shares of Class B stock. By March 31, 1943, the amount of Class A stock of Axton-Fisher owned by Transamerica had grown to 30,168 shares or about 66⅔% of the total amount of this stock outstanding, and the amount of Class B stock owned by Transamerica had increased to 90,768 shares or about 80% of the total outstanding. Additional shares of Class B stock were acquired by Transamerica after April 30, 1943, and Transamerica converted the Class A stock owned by it into Class B stock so that on or about the end of May 1944 Transamerica owned virtually all of the outstanding Class B stock of Axton-Fisher. Since May 16, 1941, Transamerica had control of and had dominated the management, directorate, financial policies, business and affairs of Axton-Fisher. Since the date last stated Transamerica had elected a majority of the board of directors of Axton-Fisher. These individuals are in large part officers or agents of Transamerica.

In the fall of 1942 and in the spring of 1943 Axton-Fisher possessed as its principal asset leaf tobacco which had cost it about $6,361,981. This asset was carried on Axton-Fisher's books in that amount. The value of leaf tobacco had risen sharply and, to quote the words of the complaint, "unbeknown to the public holders of * * * Class A common stock of Axton-Fisher, but known to Transamerica, the market value of * * * [the] tobacco had, in March and April of 1943, attained the huge sum of about $20,000,000."

The complaint then alleges the gist of the plaintiff's grievance, viz., that Transamerica, knowing of the great value of the tobacco which Axton-Fisher possessed, conceived a plan to appropriate the value of the tobacco to itself by redeeming the Class A stock at the price of $60 a share plus accrued dividends, the redemption being made to appear as if "incident to the continuance of the business of Axton-Fisher as a going concern", and thereafter, the redemption of the Class A stock being completed, to liquidate Axton-Fisher; that this would result, after the disbursal of the sum required to be paid to the preferred stock, in Transamerica gaining for itself most of the value of the warehouse tobacco. The complaint further alleges that in pursuit of this plan Transamerica, by a resolution of the Board of directors of Axton-Fisher on April 30, 1943, called the Class A stock at $60 and, selling a large part of the tobacco to Phillip-Morris Company, Ltd., Inc., together with substantially all of the other assets of Axton-Fisher, thereafter liquidated Axton-Fisher, paid off the preferred stock and pocketed the balance of the proceeds of the sale. Warehouse receipts rep-

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mined in such manner as the Board of Directors shall prescribe; provided, however, that no holder of Class A common stock shall be preferred over any other holder of such stock."

resenting the remainder of the tobacco were distributed to the Class B stockholders.

Assuming as we must that the allegations of the complaint are true, it will be observed that agents or representatives of Transamerica constituted Axton-Fisher's board of directors at the times of the happening of the events complained of, and that Transamerica was Axton-Fisher's principal and controlling stockholder at such times. It will be observed also that jurisdiction in the suit at bar is based upon diversity of citizenship and jurisdictional amount. In such a suit the conflict-of-laws rule of Delaware required the District Court of Delaware to refer to the law of the State of incorporation to determine the extent and nature of relationships between corporation and stockholder, corporate officer or director and stockholder and between stockholders *inter sese*. See Skillman v. Conner, 8 W.W.Harr. 402, 193 A. 563, and Black & Yates v. Mahogany Ass'n, 3 Cir., 129 F.2d 227, 233. As was well stated by the court below in Geller v. Transamerica Corporation, D.C. 53 F.Supp. 625, 629–630, "* * * under the Delaware conflict of laws rule the law of the place of the wrong determines the quantum of the breach of duty * * * It would seem that the place of wrong is where the final act occurred which establishes liability." This court approved that reasoning by affirming per curiam the decision. See, 3 Cir., 151 F.2d 534.

The *loci* of the events complained of in the instant case are not set forth in the complaint. In Black & Yates v. Mahogany Ass'n, 129 F.2d at p. 233, we stated, "We think that in the absence of allegations as to the place or places where the acts complained of occurred, the court below would have been entitled to assume that these operative facts took place within the State of Delaware", viz., the state of the forum. It is necessary therefore to assume that the events complained of took place within the State of Delaware. The law of Kentucky determines the existence of fiduciary duty, or the lack of it, between Transamerica (as the board of directors of Axton-Fisher, as its officership or as its controlling stockholder) and Axton-Fisher's minority Class A stockholders, and the law of Delaware determines the extent of the breach of fiduciary duty, if any.

Transamerica leans heavily upon the decision of the Court of Appeals of Kentucky in Taylor v. Axton-Fisher Tobacco Co., 295 Ky. 226, 173 S.W.2d 377, and to a lesser extent upon the decision of the court below in the Geller case. The latter authority held that a majority stockholder of a corporation is at liberty to deal at arm's length with a minority stockholder who sought to sell and did sell his stock to the majority stockholder in the absence of affirmative misrepresentation or fraud by the latter. This was a correct application of the law of Kentucky.[25] See Waller v. Hodge, 214 Ky. 705, 283 S.W. 1047,

[25] The rule of law stated is analogous to that applicable when a director buys the stock of a stockholder. On this subject Thompson on Corporations, 3rd Ed., Section 1363, pp. 885 et seq., states: "On the proposition of the right or power of a director to deal with a stockholder in the purchase of his stock on an equal footing, the cases are diametrically opposed." But see Fletcher Cyc. Corporations, Section 1168. The view of the Delaware courts is the same as that of the Kentucky courts. See Cahall v. Lofland, 12 Del.Ch. 299, 114 A. 224, affirmed 13 Del.Ch. 384, 118 A. 1.

and Barth v. Fidelity & Columbia Trust Company, 188 Ky. 788, 224 S. W. 351. These decisions and that of the Geller case are not apposite under the circumstances of the instant case.

The decision of the Court of Appeals of Kentucky in the Taylor case requires careful analysis. The following appears. Charlotte Taylor, a citizen of Jefferson County, Kentucky, sued Axton-Fisher in the Jefferson Circuit Court, Chancery Branch, First Division, stating that she was the holder of nine shares of its Class B stock and, setting up in her complaint the provisions of Axton-Fisher's charter hereinbefore referred to, alleged that Axton-Fisher's board of directors by a resolution of June 16, 1943 had provided that the Class A stock not presented for redemption on or before July 1, 1943, should "continue in full force and effect with all the rights and privileges thereunto appertaining, as fully as if the call for redemption [pursuant to the resolution of April 30, 1943] had never been issued * * *" and that those Class A stockholders who had surrendered their stock for redemption might change their positions and remain as Class A stockholders of their corporation provided rescissions of surrenders of their stock were filed with the corporation's agent on or before July 1, 1943. Taylor alleged, in short, that by the resolution of June 16, 1943 the board of directors attempted to change the call for the redemption of the Class A stock from a mandatory to an optional one, leaving it to the choice of the stockholders whether they would surrender their stock or not. Taylor asked the court to declare that the resolution of the board of April 30, 1943 was a final and irrevocable act of the board of directors, binding upon Axton-Fisher and on all Class A stockholders; that the attempted modification of the terms of the resolution of April 30, 1943 by the resolution of June 16, 1943 was void and that Axton-Fisher was required to carry out the redemption of the Class A stock as provided by the resolution of April 30, 1943.

A demurrer was filed and the cause proceeded to judgment. The Circuit Court of Jefferson County held that the board of directors had the right to modify the call embodied in the resolution of April 30 by the resolution of June 16. A brief opinion was filed. The case was appealed to the Court of Appeals of Kentucky. See 295 Ky. 226, 173 S.W.2d 377, 379, 148 A.L.R. 834. That Court, speaking through Commissioner Stanley, one Judge dissenting, stated inter alia: "The rights of the holders of Class A stock and of the corporation as to its redemption rested on an express contract, namely, the provision of the articles of incorporation which made them junior preferred stockholders *and subject at all times to have their stock retired,*" citing Thompson on Corporations, Sections 189, 210; 13 Am.Jur., Corporations, Section 318; Fletcher, Section 5443; Westerfield-Bonte Co. v. Burnett, 176 Ky. 188, 195 S.W. 477; F. T. Gunther Grocery Co. v. Hazel, 179 Ky. 775, 201 S.W. 336, and other authorities. Commissioner Stanley went on to say: "Manifestly, it was very much to the interest of the holders of Class B stock to have all these priorities, obligations and restrictions on and conditional joint control of the management eliminated. A substantial advantage was given to and acquired by the Class B stockholders by the resolution definitely and unqualifiedly calling Class A

stock for redemption. That being true, it was vested and fixed, so that the directors could not withdraw or cancel or modify their action to the prejudice or detriment of Class B stockholders.

"The first action of the directors may not be regarded as but an offer or proffer, or in the nature of such, capable of being withdrawn before acceptance or consummation. Rather it is the converse. The charter provision constituted a continuing contractual power and corresponding right which only waited action by the directors for use and consummation. It was a continuing option." Commissioner Stanley said that while the acts of boards of directors, exercised in good faith and not in fraud of the rights of the stockholders, should not be interfered with by the courts,[26] if the prior action of the board of directors had vested rights in others the board could "not [subsequently] alter or affect those rights * * *". Discussing Axton-Fisher's charter provisions at some length, Commissioner Stanley stated, "* * * we [cannot] agree with the appellee [Axton-Fisher] that the result of this action of the directors is to be regarded only as an incidental benefit flowing to the Class B stockholders since they were not promisees of the [redemption] contract nor parties to whom performance was to be rendered. * * * The provision of the articles of incorporation and the effect of the action of the directors are too substantial and too great to be so regarded. *We think the provision for redemption of Class A stock was made as much for the one as for the other class. If it was not, then it was very delusive.*

"The principle applicable in cases where there has been a declaration of dividends is applicable here. Undivided profits of a corporation in a sense or qualifiedly belong to the stockholders, *but disposition or distribution thereof rests within the fair discretion of the directors.*" [27] citing Smith v. Southern Foundry Co., 166 Ky. 208, 179 S.W. 205.

The circumstances of the case at bar are *sui generis* and we can find no Kentucky decision squarely in point. In our opinion, however, the law of Kentucky imposes upon the directors of a corporation or upon those who are in charge of its affairs by virtue of majority stock ownership or otherwise the same fiduciary relationship in respect to the corporation and to its stockholders as is imposed generally by the laws of Kentucky's sister States or which was imposed by federal law prior to Erie R. Co. v. Tompkins, 304 U.S. 64, 58 S.Ct. 817.

The tenor of the federal decisions in respect to the general fiduciary duty of those in control of a corporation is unmistakable. The Supreme Court in Southern Pacific Co. v. Bogert, 250 U.S. 483, 487, 488, 39 S.Ct. 533, 535, said: "The rule of corporation law and of equity invoked is well settled and has been often applied. The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors." In Pepper v. Litton, 308 U.S. 295, 306, 60 S.Ct. 238, 245, the Supreme Court stated: "A director is a fiduciary.

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26 Citing KRS 271.230.

27 Emphasis added to all of the foregoing quotations from the Taylor case.

* * * So is a dominant or controlling stockholder or group of stockholders. * * * Their powers are powers in trust. * * * Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged, the burden is on the director or stockholder not only to prove the good faith of the transaction, but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."

See also Hyams v. Calumet & Hecla Mining Co., 6 Cir., 221 F. 529, 537, "* * * the rule, independently of state or national anti-trust statutes, is fundamental that one in control of majority of the stock and of the board of directors of a corporation occupies a fiduciary relation towards the minority stockholders, and is charged with the duty of exercising a high degree of good faith, care, and diligence for the protection of such minority interests. Every act in its own interest to the detriment of the holders of minority stock becomes a breach of duty and of trust, and entitles to plenary relief from a court of equity. Jackson v. Ludeling, 88 U.S. 616, 21 Wall. 616, 624, 625, 22 L.Ed. 492; Jones v. Electric Co., 8 Cir., 144 F. at page 771, [Missouri Edison] 75 C.C.A. 631; Wheeler v. Abilene, etc., Bldg Co., 8 Cir., 159 F. 391, 394, 395, 89 C.C.A. 477, 16 L.R.A.,N.S., 892, 14 Ann.Cas. 917; 3 Clark & Marshall on Corporations, at page 2289." See in particular Lebold v. Inland Steel Co., 7 Cir., 125 F.2d 369. Cf. Lebold v. Inland S. S. Co., 7 Cir., 82 F.2d 351.

The law of the States in this respect is illustrated by such decisions as Singer v. Carlisle, Sup., 26 N.Y.S.2d 172; Pearson v. Concord Railroad Corporation, 62 N.H. 537, 13 Am.St.Rep. 590; Miner v. Belle Isle Ice Co., 93 Mich. 97, 53 N.W. 218, 17 L.R.A. 412; Bailey v. Jacobs, 325 Pa. 187, 189 A. 320; Lofland v. Cahall, 13 Del.Ch. 384, 118 A. 1. See also 19 C.J.S., Corporations, § 764: "The directors owe a duty of managing the corporate affairs honestly and impartially in behalf of the corporation and all the stockholders * * *." See also Restatement of the Law of Trusts, Section 170. Most of the decisions cited were rendered under circumstances in which one corporation controlled another as in the case at bar. The means of control is of course immaterial. See Fletcher Cyclopedia Corporations, Permanent Ed., Vol. 13, Section 5842.

The law of Kentucky also demonstrates the fact that those in charge of a corporation stand in a fiduciary relation to its minority stockholders. * * *

In Kirwan v. Parkway Distillery, 285 Ky. 605, 148 S.W.2d 720, 723, the Court of Appeals of Kentucky had before it the following facts. The majority stockholders of a corporation voted to dissolve it because the minority stockholders objected to a sale of the corporate assets. It appeared that the minority stockholders desired to obtain the book value of their stock in lieu of the prorata share of the funds remaining after the sale of the corporate assets. The minority stockholders filed a bill to restrain the dissolution. The Court of Appeals of Kentucky sustained a demurrer to the complaint, stating in part: "It is claimed that the dissolution of Bonnie Bros. corporation subsequent to the con-

tract of sale of its assets was done for the purpose of defeating the appellants' rights to the book value of their stock which was more remunerative to them than their proportionate shares of the assets under a dissolution of the corporation. Conceding that to be true, yet the stockholders when voting strictly as stockholders were still within their legal rights. In the case of Haldeman v. Haldeman et al., 176 Ky. 635, 197 S.W. 376, it is pointed out that *there is a radical difference when a stockholder is voting strictly as a stockholder and when voting as a director. When voting as a stockholder he has the legal right to vote with a view of his own benefits and is representing himself only; but, a director represents all the stockholders in the capacity of trustee for them and cannot use his office as director for his personal benefit at the expense of the stockholders.* * * *

There can be no doubt of the general law upon this question. It is succinctly stated in Thompson on Corporations, supra, Section 1337, as follows: "Very plainly a director is disqualified from voting on matters in which he has a personal interest or on matters concerning the personal interest of a director who controls his vote. The rule is that any resolution passed at a meeting of the directors at which a director having a personal interest in the matter voted, will be voidable at the instance of the corporation or the stockholders, without regard to its fairness, where the vote of such directors was necessary to the passage of such resolution." It is clear that under the law of Kentucky the fiduciary relationship of directors is such that a court of equity will not permit them to make a profit of their trust and that directors of a corporation are required to manage and conduct their trust so as to realize whatever profit may accrue in the course of the business for the benefit of their *cestuis que trust.*

It is appropriate to emphasize out at this point that the right to call the Class A stock for redemption was confided by the charter of Axton-Fisher to the directors and not to the stockholders of that corporation. We must also re-emphasize the statement of the court in Haldeman v. Haldeman, supra, and its reiteration in Kirwan v. Parkway Distillery, supra, that there is a radical difference when a stockholder is voting strictly as a stockholder and when voting as a director; that when voting as a stockholder he may have the legal right to vote with a view of his own benefits and to represent himself only; but that when he votes as a director he represents all the stockholders in the capacity of a trustee for them and cannot use his office as a director for his personal benefit at the expense of the stockholders.

Two theories are presented on one of which the case at bar must be decided: one, vigorously asserted by Transamerica and based on its interpretation of the decision in the Taylor case, is that the board of directors of Axton-Fisher, whether or not dominated by Transamerica, the principal Class B stockholder, at any time and for any purpose, might call the Class A stock for redemption; the other, asserted with equal vigor by Zahn, is that the board of directors of Axton-Fisher as fiduciaries were not entitled to favor Transamerica, the Class B stockholder, by employing the redemption provisions of the charter for its benefit.

We must of course treat the decision of the Court of Appeals of Kentucky in the Taylor case as evidence of what is the law of Kentucky. The Court took the position on that record that the directors at any time[28] might call the Class A stock for redemption and that the redemption provision of the charter was written as much for the benefit of the Class B stock as for the Class A stock.[29] It is argued by Transamerica very persuasively that what the Court of Appeals of Kentucky held was that when the Class A stock received its allocation of $60 a share plus accrued dividends it received its full due and that the directors had the right at any time to eliminate Class A stock from the corporate setup for the benefit of the Class B stock.[30] It does not appear from the opinion of the Court of Appeals of Kentucky whether or not the subsequent liquidation of Axton-Fisher was brought to the attention of the Court. But it is clear from the pleading that the subsequent liquidation was not an issue in the case and from the language of the Court there is some indication that it believed that Axton-Fisher was to continue in existence because Commissioner Stanley spoke of the elimination of the Class A stock, which possessed voting rights, from the management and control of Axton-Fisher. Such surmises are hazardous, however, and are not really apposite since it is our duty to determine the law of Kentucky and not to delve into subjective mental processes. It should be noted that Commissioner Stanley stated the justiciable controversy before the Court of Appeals of Kentucky as follows: "The case presents a novel question of power of the board of directors of a corporation to rescind or modify its action in calling certain stock for redemption or retirement." This, and only this, was the question before the Court. It is notable that Commissioner Stanley said also that the acts of boards of directors "exercised in good faith and not in fraud of the rights of stockholders" should not be interfered with by the courts and that he spoke as well of the "fair discretion" of directors to be exercised in the same manner as would be the case in the declaration of dividends, citing Smith v. Southern Foundry Co., referred to in the body of this opinion. We think that it is the settled law of Kentucky that directors may not declare or withhold the declaration of dividends for the purpose of personal profit or, by analogy, take any corporate action for such a purpose.

The difficulty in accepting Transamerica's contentions in the case at bar is that the directors of Axton-Fisher, if the allegations of the complaint be accepted as true, were the instruments of Transamerica, were directors voting in favor of their special interest, that of Transamerica, could not and did not exercise "an independent judgment" in calling the Class A stock, but made the call for the purpose of profiting their true principal, Transamerica. In short, a puppet-puppeteer re-

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28 The phrase used by the Court of Appeals of Kentucky was "at all times."

29 The language used as quoted supra was as follows: "We think the provision for redemption of Class A stock was made as much for the one as for the other class. If it was not, then it was very delusive."

30 The court said: "Manifestly, it was very much to the interest of the holders of Class B stock to have all these priorities, obligations and restrictions on and conditional joint control of the management eliminated. A substantial advantage was given to and acquired by the Class B stockholders. * * *"

lationship existed between the directors of Axton-Fisher and Transamerica.

The act of the board of directors in calling the Class A stock, an act which could have been legally consummated by a disinterested board of directors, was here effected at the direction of the principal Class B stockholder in order to profit it. Such a call is voidable in equity at the instance of a stockholder injured thereby. It must be pointed out that under the allegations of the complaint there was no reason for the redemption of the Class A stock to be followed by the liquidation of Axton-Fisher except to enable the Class B stock to profit at the expense of the Class A stock. As has been hereinbefore stated the function of the call was confided to the board of directors by the charter and was not vested by the charter in the stockholders of any class. It was the intention of the framers of Axton-Fisher's charter to require the board of directors to act disinterestedly if that body called the Class A stock, and to make the call with a due regard for its fiduciary obligations. If the allegations of the complaint be proved, it follows that the directors of Axton-Fisher, the instruments of Transamerica, have been derelict in that duty. Liability which flows from the dereliction must be imposed upon Transamerica which, under the allegations of the complaint, constituted the board of Axton-Fisher and controlled it.

The *quantum* or extent of the breach of the fiduciary duty on the present record must be determined according to the law of Delaware for the reasons hereinbefore stated. The reaction of the law of Delaware to such a course as that pursued here by Transamerica is suggested by such decisions of the Supreme Court of Delaware as Bovay v. H. M. Byllesby & Co., Del.Sup., 38 A.2d 808, and Keenan v. Eshleman, 23 Del.Ch. 234, 2 A.2d 904, 120 A.L.R. 227. But whether the law of Delaware be applicable to determine the extent of the breach of fiduciary duty, or that of Kentucky or of New York, there will be found to be no substantial difference.[31] The remedies to be afforded by the District Court of the United States for the District of Delaware, of course, must be those which may be available under the law of Delaware. See Guaranty Trust Co. v. York, 326 U.S. 99, 65 S.Ct. 1464, 89 L.Ed. 2079, 160 A.L.R. 1231, and Overfield v. Pennroad Corporation, 3 Cir., 146 F.2d 889.

As has been stated the plaintiff has endeavored to set up a "First Cause of Action" and a "Second Cause of Action" in his complaint. The first cause of action is based upon his ownership of shares of Class A stock not surrendered by him to Axton-Fisher for redemption and is asserted not only on his own behalf but also on behalf of other Class A stockholders retaining their stock. The second cause of action is asserted by him on his own behalf and on behalf of other Class A stockholders in respect to the value of the stock which was surrendered for redemption. The two alleged separate causes of action, however, are in reality one.[32] In our opinion, if the allegations of the complaint

31 The general law is set out in the Restatement, Restitution, Section 190. See *Comment a.* Fiduciary Relations.

32 The second cause of action refers to the resolution of the board of directors

be proved, Zahn may maintain his cause of action to recover from Transamerica the value of the stock retained by him as that shall be represented by its aliquot share of the proceeds of Axton-Fisher on dissolution. It is also our opinion that he may maintain a cause of action to recover the difference between the amount received by him for the shares already surrendered and the amount which he would have received on liquidation of Axton-Fisher if he had not surrendered his stock.[33] For analogy see Lebold v. Inland Steel Co., supra; Jones v. Missouri-Edison Electric Co., 8 Cir., 144 F. 765; Id., 8 Cir., 199 F. 64, certiorari denied 229 U.S. 615, 33 S.Ct. 174, 57 L.Ed. 1352; Richardson v. Blue Grass Mining Co., D.C., 29 F.Supp. 658, and Willcox v. Harriman Securities Corporation, D.C., 10 F.Supp. 532. * * *

The judgment will be reversed.

(b) Preemptive Rights of Preferred Stock

GENERAL INV. CO. v. BETHLEHEM STEEL CORPORATION.

Court of Chancery of New Jersey, 1917. 88 N.J.Eq. 237, 102 A. 252.

LANE, V. C. (orally): This is an application for a preliminary injunction restraining the Bethlehem Steel Corporation from increasing its capital by the issuance of thirty million of stock termed "Eight Per Cent. Cumulative Convertible Preferred." A meeting is to be held to-morrow at eleven o'clock. The Court of Errors and Appeals, I understand, is in session and application for any ad interim relief on appeal may be made to that court tomorrow morning. That is the reason why I have changed my mind and have concluded to decide the case at this time.

The application is made by General Investment Company and Continental Securities Company, other names for one Venner. They are holders respectively of one hundred shares of the present common and one hundred shares of preferred stock, and the application is made on behalf of both interests. Venner (and I shall use his name in place of the names of his corporations) bought his common stock in January of this year, as I find, for the sole purpose of harassing in any way that he could the stockholders and directors of this corporation. At the time the specific purpose that he had in mind was to prevent a scheme of financing which was then under discussion. He bought his preferred stock after notice of the present plan and for the specific purpose of preventing its success. He is entitled from a court of equity to only such consideration as that court is absolutely bound

of Axton-Fisher of June 16, 1943, hereinbefore referred to in this opinion, and the fact that that resolution was declared to be invalid by the Court of Appeals of Kentucky as has been stated. These facts are immaterial as we view the law applicable to the suit at bar. It is not within the jurisdiction of this court to pass upon the questions presented by the two resolutions, the effects of which were adjudicated by the Court of Appeals of Kentucky.

[33] As to Zahn's present and past ownership of Class A stock see note 22, p. 583, supra.

under rules of law to accord him.[34] The company at the present time has a preferred stock issue of $15,000,000; and a common stock issue of $60,000,000. The common stock is divided into two classes, fifteen million termed "Common" and forty-five million termed "Common Class B." The voting power is possessed only by the preferred fifteen million and the common fifteen million. It is now proposed to issue a new stock to the amount of $30,000,000 at a dividend rate of eight per cent., which will be preferred, as to dividends, to the present preferred and common and will share in distribution with the present preferred pari passu. This stock is to be redeemable at the option of the corporation after three years at one hundred and fifteen. It is to be convertible into common class B at the option of the holder at any time. * * *

It is next objected that the present preferred stock is not given the right to subscribe to the new preferred. Generally speaking, I think the law is well settled that unless there is something in the certificate of incorporation to the contrary the rights of preferred and common stockholders are equal. Whether a particular right is enjoyed equally by both, however, must depend upon the reason for the existence of the right; at least, a very strong argument may be made to that effect. It will be observed that the present preferred has no right in the assets except to the extent of par and accrued dividends. The reason for the existence of the pre-emptive right of subscription is that the relative rights of the existing stockholders both in the assets of the company and in its control may not be altered. The relative interest of the present preferred stock in the assets of the company is not affected by the present scheme. The proposed preferred stock has no voting power so that the relative interest in the control is not affected. It is argued with force that to permit the present preferred to subscribe for the proposed preferred would be to permit a change in the relative rights of the present preferred and common and would be illegal. Of course, if the reason for the rule fails, the rule is not to be applied. * * *

Without deciding, therefore, any of the questions raised, solely upon balancing the conveniences I will discharge the order to show cause.

NOTE

"In modern times common shares as well as preferred shares are sometimes issued without voting rights, and preferred shares are ordinarily issued with preferential rights to dividends at a specified rate, but with no right to participate with the holders of common shares in further distributions of profits or of surplus. Under these circumstances, a rule of preemptive rights cannot be applied without considering the rights and equities of the different classes of shareholders. * * * the issue of additional common shares without voting rights would not be prejudicial to the holders of non-participating preferred shares even though the additional common shares be given as a share dividend to the holders of common shares

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34 Venner had already sought a temporary injunction to restrain an increase of the capital stock of the corporation. See, General Investment Co. v. Bethlehem Steel Co., supra, p. 517.

See, Note, Stockholder's Suit for Wrong Which Occurred before Complainant Acquired Stock, 1934, 68 U.S.L.Rev. 169.

and participating shares * * *" Morawetz, The Preemptive Right of Shareholders, 1928, 42 Harv.L.Rev. 186, 193–194. See, also, Drinker, The Preemptive Right of Shareholders to Subscribe to New Shares, 1930, 43 Harv.L.Rev. 586, 605–606, 609–616; Frey, Shareholders' Pre-emptive Rights, 1929, 38 Yale L.J. 563, 563–578; Hills, Preferred Stockholders' Right to Subscribe to New Shares, 1927, 5 N.Y.L.Rev. 207; Notes, 1913, 13 Col.L.Rev. 146; 1912, 26 Harv.L.Rev. 75; see pages 332 to 355, *supra*, on preemptive rights.

STONE v. UNITED STATES ENVELOPE CO.

Supreme Judicial Court of Maine, 1920.
119 Me. 394, 111 A. 536, 13 A.L.R. 422.

On report. This is a bill in equity brought by Carrie M. Stone, one of the holders of common shares in the capital stock of defendant corporation, seeking an injunction to restrain defendants from issuing to the preferred and common stockholders in proportion to the number of shares held by each, 2500 shares of common stock $100 par value. The cause was heard and reported to the Law Court for determination. Bill sustained; decree to be signed by single Justice in accordance with this opinion.

DEASY, J. Equity. The part of the by-laws of the United States Envelope Co. material to the present case is as follows:

"Article XVI. Capital.

"The shares of this corporation shall be divided as follows, viz.: 10,000 common shares, 40,000 preferred shares.

"The preferred shares shall be entitled to cumulative dividends payable semi-annually out of the net earnings of the corporation, at the rate of seven per cent., per annum, before any dividends are declared or paid on the common shares, and in case of non-payment in full of any such semi-annual dividends, the portions unpaid shall be paid out of subsequent net earnings prior to the claims of the common shares, but without interest on deferred payments, and the preferred shares shall have preference over the common shares in any distribution of the assets of the corporation in liquidation."

The by-laws also give to the common and preferred stockholders equal voting power share for share and provided that "any shares of stock not subscribed for at the first meeting may be issued by the Board of Directors." [35]

All the stock has been issued and sold for cash at par except 2500 shares of common stock. A vote has been passed to issue this stock and to offer it to stockholders both common and preferred, in proportion to their holdings, at $150 per share, a price which the case shows to be materially below its value.

The plaintiff holding 1000 shares of the common stock asks that the defendant may be enjoined from carrying this vote into effect on the ground that to give the preferred shareholders a preemptive right to purchase common stock at less than its value is in effect to pay them a dividend in addition to the seven per cent. provided for in the by-

35 *Sed quaere*, in view of this by-law, may not the directors sell unsubscribed shares to whom they will?

laws and which they have received. The defendants contend that the preferred stockholders notwithstanding that they have received their preferential dividends are entitled to share in the surplus equally with the holders of the common stock.

The respective rights of holders of common and preferred stock are fixed by contract. Spear v. Rockland-Rockport Lime Co., 113 Me. 285, 93 A. 754, 6 A.L.R. 793.

The contract is commonly contained in the corporate by-laws. Within wide limitations any preferential rights provided for in the by-laws will be given effect to by courts.

The question at issue in this case relates to the extent and limits of the rights that prima facie belong to preferred stock as such i. e. rights and limitations that, in the absence of express provisions, are implied.

The plaintiff contends that where a say seven per cent. preferred stockholding is created with no stipulation in reference to participation in surplus, the preferred stockholder is entitled to seven per cent., and that all the rest of the profits available for distribution belong to the holders of common stock; on the other hand the defendant says that after payment of the seven per cent. dividend and perhaps an equal dividend upon the common stock, the balance of profits to be distributed must go to all the stockholders both common and preferred in proportion to their holdings and without discrimination.

Both parties present authorities sustaining their respective contentions. There are two opposing theories each of which has judicial support. One theory is that the preferred stockholder presumptively yields nothing in compensation for the benefits which he receives; that he has and holds all the rights of the common shareholder and in addition has his preferential rights. * * *

Independent reasoning as well as what we deem to be the preponderance of authority sustains the plaintiff's position. Words in contracts, as well as in statutes, should ordinarily be construed "according to the common meaning of the language." Surely the phrase "preferred stock" holds out to the ear of the ordinary investor no promise of participation in earnings beyond his preferential dividend. That this is true has been recognized by authorities.

"It is generally assumed that where preferred shares are given a fixed preferential dividend at a specified rate, that impliedly negatives any right to take any further dividends." Palmer's Company Precedents, 11th Ed., 814.

"Preferential shares and stock are ordinarily spoken of and regarded, and I think properly regarded, as shares or stock which carry a fixed preferential dividend and are not entitled to anything more." Will v. United Lankat Plantations Co., L.R. [1912] 2 Ch.Div. 571.

Even Cook whose work on Corporations is repeatedly and confidently cited by the defendant says: "Theoretically it is difficult to justify this conclusion, but practically it is true that the investing public assume and understand that preferred stock is never entitled to more than its specified and fixed dividends." Cook, 7th Ed., § 269 note.

There are disclosed in this case significant circumstances showing that the above opinion harmonizes with the actual intention of the persons interested in the organization of this corporation.

We put the decision however upon the ground that where nothing to the contrary appears the creation of preferred stock prima facie implies that the preferential rights of the stockholder are given in lieu of and to the exclusion of the equality in participation which would otherwise exist.

Some cases indicate a distinction in respect to the relative rights of common and preferred stockholders, between an earned surplus and an "unearned increment" i. e., a surplus arising from an increase in value of corporate property.

It is not necessary to here consider this distinction inasmuch as the surplus in the present case is admittedly an accumulation of corporate earnings.

Bill sustained with costs.

4. CONVERTIBLE PREFERRED STOCK [36]

NEW YORK STOCK CORPORATION LAW

§ 27. *Convertible shares.* 1. A stock corporation by its certificate of incorporation or by a certificate pursuant to section thirty-six, may provide that any of its authorized shares, issued or unissued, with or without par value, shall be convertible at the option of the holders thereof into shares of any other class or classes, or into shares of any other series of the same class, with or without par value, upon such terms and conditions and with such limitations as may be stated in the certificate; but no convertible shares so authorized shall be issued, nor shall issued shares be changed into convertible shares, nor shall the conversion privileges of issued convertible shares be changed, unless at the time of such issuance or such change in issued shares the capital represented by the convertible shares plus the additional value, if any, which must be paid upon conversion, is at least equal to the contribution to capital required by law for the shares to be issued pursuant to the conversion.

2. The certificate authorizing the convertible shares may provide for a change in the basis of conversion upon the taking by the corporation of certain action which is specified. Such action shall not be taken, however, or, if taken, shall not be effective, unless after the action has been taken the capital represented by the convertible shares plus the additional value, if any, which must be paid upon conversion for the shares to be issued, is at least equal to the contribution to capital required by law for the shares to be issued pursuant to the conversion.

3. Where any part of the capital of the corporation has not been allocated to any class of shares or consists of amounts transferred to

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[36] See, Berle, Convertible Bonds and Stock Purchase Warrants (1927) 36 Yale L.J. 649; Hills, Convertible Securities-Legal Aspects and Draftsmanship (1930) 19 Calif. L.Rev. 1.

capital by resolution of the board of directors, in determining for the purposes of this section the capital represented by the convertible shares, the board of directors may allocate to the capital represented by any class of convertible shares, all or any part of such unallocated or transferred capital. Such allocation of capital shall be effective solely for the purpose of determining whether the requirements of this section have been complied with, and shall not have any other effect. The capital represented by each convertible share, for the purposes of this section, shall be determined by dividing the total capital represented by all the issued shares of the same class, including any amounts allocated thereto under the provisions of this section, by the number of such issued shares. If the statement respecting capital is that prescribed in paragraph B of subdivision four of section twelve, (a) the capital represented by each class of convertible shares without par value shall be the aggregate amount of consideration received for all the issued shares of such class, together with any other amounts allocated to such class by the directors, and (b) the corporation shall be deemed to have received for the issuance of the shares resulting from the conversion, the amount of the capital of the corporation theretofore represented by the converted shares, plus such part of any additional value paid upon conversion as may be required by the certificate or this section to be capital.

4. No conversion shall result in a reduction of the corporation's capital. So much of the capital represented by converted shares, and any additional value paid to the corporation upon conversion, as together shall equal the contribution to capital required by law for the shares issued pursuant to conversion, shall be deemed to be capital represented by the shares so issued. Any additional capital represented by converted shares, and, if so provided in the certificate, any additional value so paid, also shall be capital, and shall be deemed, in computing the corporation's capital and for the purposes of this section, to have been transferred to capital as if by resolution of the board of directors.

5. Shares which have been converted shall forthwith revert to the status of unissued shares and shall not be reissued. The corporation may eliminate any shares so converted by filing a certificate which shall be entitled and endorsed "Certificate of elimination of converted shares of (name of corporation) pursuant to section twenty-seven of the stock corporation law." Such certificate shall contain the statements prescribed by section thirty-six for like certificates under subdivision (C) of said section and shall be filed as provided in section thirty-eight in respect of certificates under section thirty-six; it need not, however, state the designations, preferences, privileges and voting powers or restrictions or qualifications, of previously authorized shares. The certificate shall be subscribed and acknowledged by the president or a vice president and the secretary or an assistant secretary, who shall make and annex an affidavit stating that they have been authorized to execute and file such certificate by resolution of the board of directors, adopted at a directors' meeting duly called and held on a date specified in such affidavit.

6. The corporation at the time of authorizing convertible shares shall provide for and at all times thereafter shall retain unissued, sufficient shares of appropriate classes to satisfy the conversion privileges of all its issued convertible shares.

7. The corporation shall not in any manner decrease the capital represented by issued convertible shares, nor change such shares nor the shares issuable pursuant to the conversion thereof, nor increase or reduce the number or par value of any such shares, unless thereafter the capital represented by the issued convertible shares plus the additional value, if any, which must be paid upon conversion, shall be at least equal to the contribution to capital required by law for the shares to be issued pursuant to the conversion.

8. Nothing contained in this section shall confer any powers or impose any duties upon moneyed corporations or in any way affect the powers and duties of such corporations.

DELAWARE GENERAL CORPORATION LAW.

§ 13. *Classes of stock,* supra, p. 224.

MARONY v. WHEELING & LAKE ERIE RAILWAY COMPANY.

District Court of the United States, D. New York, 1929. 33 F.2d 916.

At Law. Action by Robert J. Marony against the Wheeling & Lake Erie Railway Company. On plaintiff's motion to strike out certain allegations of the answer, and defendant's motion to dismiss the complaint. Plaintiff's motion granted, and defendant's motion denied.

BONDY, DISTRICT JUDGE. This action was brought to recover damages alleged to have been sustained by defendant's refusal to convert preferred into common stock. In the two causes of action set forth in the complaint it is alleged that the certificate of incorporation of defendant provides that its preferred stock shall be convertible into common stock, dollar for dollar of par value, and that on presentation and surrender to the corporation at its stock transfer agency of certificates of shares of preferred stock so to be converted, the holder of such stock shall be entitled to receive in exchange therefor certificates for shares of common stock at the rate aforesaid, and that the certificates representing the shares of preferred stock provide likewise that shares of preferred stock are convertible into common stock upon surrender to the company at any transfer agency of the certificates for shares of preferred stock so to be converted. * * *

The statement by the defendant, in its certificate of incorporation and stock certificate, that any holder of preferred stock may convert such stock into common stock, imposed the obligation on defendant to use reasonable diligence to do everything necessary to keep itself in readiness lawfully to comply with its promise to convert its preferred stock on presentation and surrender, and therefore imposed the obligation on it to obtain with diligence the approval of the Commission. * * *

The complaint alleges a breach of contract by the defendant, giving rise to a cause of action. If the plaintiff did anything after the cause

of action arose, whereby he waived his right of action or released defendant from liability to him, or ceased to be a party in interest, these facts should be set up as an affirmative defense. * * *

Motion to strike out first affirmative defense is therefore granted, and motion to dismiss complaint denied.

HILLS, GEO. S., "CONVERTIBLE SECURITIES—LEGAL ASPECTS AND DRAFTSMANSHIP" (1931) 19 Calif.L.Rev. 1, 20–22:

"Instruments creating or evidencing the conversion privilege generally anticipate such changes in the corporate structure as might cause a dilution, change or destruction of the privilege, and provide adjustments and restrictions for its protection. Unless protected the conversion privilege may be changed or diluted upon the happening of the following events to the shares issuable upon conversion: A split-up or consolidation of shares; an exchange or substitution of shares; the payment of stock dividends; the issuance of additional shares for less than a fixed consideration; the issuance of other securities convertible into the same class of shares at a lesser rate or price; the issuance of subscription rights with or without a contemporaneous cash dividend; the distribution of assets to the holders of senior securities; or the issuance of other classes of shares having a preference upon redemption, liquidation or dissolution. Furthermore, the privilege may be destroyed upon a consolidation, merger, sale of assets or dissolution unless it is protected in the conversion instrument, by statute, or by the agreement of reorganization.

"There are few decisions on this subject and they are not helpful except as a warning against careless draftsmanship of the conversion instrument. These decisions indicate that the conversion privilege attached to a convertible obligation is subject to dilution and change at the will of the corporation, as the privilege holder is not a stockholder and has no voice in the affairs of the corporation. Mr. Justice Holmes held in a Massachusetts case that the conversion privilege 'imposes no restriction upon the obligor in regard to the issue of new stock, although the issue may be upon such terms as to diminish the value of the right. It is simply an option to take stock as the stock may turn out to be when the time for choice arrives. The bondholder does not become a stockholder by his contract in equity any more than at law.' [37] It has also been held that the holder of a convertible obligation has no vested right or title to any particular shares of stock and is not legally or equitably entitled, upon conversion, to the benefit of an issue of additional shares.[38] Under similar reasoning it has been held that the holder of a convertible bond has no ground of complaint against an adjustment in capitalization amounting practically to the splitting up of shares ten for one,[39] and that a privilege

[37] [Footnotes, author's] Parkinson v. West End Street Ry. Co. (1899) 173 Mass. 446, 53 N.E. 891.

[38] City of Aurora v. Cobb (1863) 21 Ind. 492; Pratt v. American Bell Telephone Co. (1886) 141 Mass. 225, 5 N.E. 307; Gay v. Burgess Mills (1909) 30 R.I. 231, 74 A. 714.

[39] Gay v. Burgess Mills (1909) 30 R.I. 231, 74 A. 714. In that case a corporation having an authorized capitalization of 10,000 shares of the par value of $10 per

holder, upon conversion, is not entitled to the benefit of any stock dividends paid prior to the conversion date.[40] There seem to be no related decisions upon the rights of holders of convertible stock, but except as changed by preemptive rights the rules should be the same.

"All convertible obligations of the same issue and all convertible stocks of the same class should be treated alike with respect to adjustments, whether such obligations or shares be outstanding or not at the time adjustments are made. It is a common practice of corporations to have authorized shares of convertible stock not yet issued, and not infrequently to have authorized but unissued convertible obligations. Unless such obligations or shares, when issued, carry the same conversion privilege as all others theretofore issued, confusion is bound to follow as the difference in conversion value would not appear upon the face of the stock certificate or upon the obligation. It is well to provide in the certificate of incorporation that all shares of a class of convertible stock shall be considered to have been issued and to have become outstanding immediately after the incorporation of the company notwithstanding that such shares may actually be issued and become outstanding on a subsequent date. A similar provision may be made for convertible obligations of the same issue in case all of such obligations be not issued at the same time.

"As the law affords no protection, the conversion instrument has taken its place and has covered every contingency within workable limits."

5. CHANGE OF CONTRACT RIGHTS OF PREFERRED STOCK

GOLDMAN v. POSTAL TELEGRAPH, INC.

District Court of the United States, D. Delaware, 1943. 52 F.Supp. 763.

Suit by Sidney Goldman, on behalf of himself and all other non-assenting stockholders, against the Postal Telegraph, Inc., to enforce liquidating rights. On defendant's motion to dismiss the complaint for failure to state a cause of action.

Motion granted.

LEAHY, DISTRICT JUDGE. Diversity and the requisite amount establish jurisdiction.

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share, and an issue of bonds convertible into 'Ten (10) shares of the Capital Stock of the Burgess Mills of the par value of $10 each,' reduced the par value of its shares from $10 to $1 and then increased the number of its authorized shares from 10,000 to 1,000,000 shares. Proceedings were brought primarily to enjoin the payment of certain dividends, and the corporation offered to issue, upon conversion, 100 shares of the par value of $1 per share in lieu of 10 shares of the par value of $10 per share. The court confirmed the offer, but took occasion to state that the bondholders had no grounds of complaint against a diminishing of the value of the conversion privilege.

[40] Sutliff v. Cleveland & Mahoning R. Co. (1873) 24 Ohio St. 147. A corporation, having outstanding convertible bonds, paid a stock dividend of about 47 per cent on its outstanding shares. The plaintiff demanded conversion of his bond into stock and also demanded the 47 per cent stock dividends theretofore paid, but it was held that he was limited upon conversion to the number of shares designated upon his bond without benefit of the prior stock dividend.

The occasion has never arisen for the Delaware courts to determine where a certificate of incorporation provides a preference stock is to be paid $60 per share upon liquidation before any distribution is to be made to the common stockholders whether an amendment under Sec. 26 of the Delaware Corporation Law [41] which attempts to provide that such preferred stockholder shall receive on dissolution less than the stated figure of $60 a share is valid.[42] Absent a precise holding by the state court, a federal court must examine all the available data as to what the state tribunal would probably decide under such facts.[43]

I. *The Plan.* Postal Telegraph, Inc., incorporated under the laws of Delaware in 1939 (herein called "Postal"), agreed to transfer to Western Union Telegraph Company (herein called "Western Union"), another Delaware corporation, all its assets. At the time of the agreement plaintiff owned 500 shares of non-cumulative preferred stock of Postal which, by the terms of Postal's certificate of incorporation, entitled all preferred stockholders to a payment of $60 a share on liquidation before any distribution could be made to its common stockholders. On July 5, 1943, defendant Postal proposed to its stockholders three resolutions authorizing (1) the sale of all its assets to Western Union, conditioned upon the approval by Postal's stockholders of an amendment to its certificate of incorporation referred to in (2); (2) the amendment of Postal's certificate of incorporation so as to provide that the holders of defendant's noncumulative preferred stock would receive in lieu of $60 per share on liquidation one share of Western Union B stock;[44] and (3) formal dissolution of Postal. At the stock-

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41 Rev.Code of Delaware of 1935, c. 65, Sec. 2058, p. 469.

42 The proposition was present in the plan approved by the Delaware Supreme Court in Shanik v. White Sewing Machine Corp., Del.Ch., 19 A.2d 831, but, in fairness to the Delaware courts and counsel for plaintiff in that case who are also counsel for plaintiff in the case at bar, the proposition raised here was not even suggested in Shanik.

43 It has been suggested, however, that the federal courts do not look to the state law where the corporate action taken constitutes a destruction of a right secured by the federal Constitution. See, Hottenstein v. York Ice Machinery Corp., 3 Cir., 136 F.2d 944, at page 953.

Whether the right affected in the case at bar falls within the dicta of the Hottenstein case will be discussed and ruled on in this opinion.

44 Prior to the amendment under Sec. 26, the provisions of Postal's certificate of incorporation with respect to the liquidating rights of the non-cumulative preferred stock provided: "(e) In the event of any liquidation, dissolution or winding up of the affairs of the Corporation, whether voluntary or involuntary, the holders of shares of the Non-Cumulative Preferred Stock shall be entitled to be paid, before any distribution or payment shall be made to the holders of the Common Stock or of any other class of stock ranking junior to the Non-Cumulative Preferred Stock, $60 per share plus all unpaid dividends thereon to the extent that the same shall be deemed to have been earned, as provided in subdivision (a) hereof, to the date of payment. In the event that at such date of payment the amount, if any, of the dividends deemed to have been earned on the shares of the Non-Cumulative Preferred Stock for the period between the dividend payment date next preceding such date of payment and such date of payment cannot be determined, dividends on the shares of Non-Cumulative Preferred Stock shall be deemed to have been earned at the full rate of $2.40 per share per annum for such period.

"After the making of such payment to the holders of the Non-Cumulative Preferred Stock, the remaining assets and funds of the Corporation shall be distributed among the holders of the Common Stock and of all other classes of stock ranking junior to the Non-Cumulative Preferred Stock according to their respective rights and shares. If, upon any such liquidation, dissolution or winding up of the affairs of the Corporation, whether voluntary or involuntary, the assets of the Corporation

holders' meeting held on August 10, 1943, these resolutions were passed by a requisite vote over plaintiff's express objection. This suit followed.

The Postal-Western Union agreement provides that for the transfer of all the assets of Postal to Western Union, Postal will receive as part consideration 308,124 shares of Class B stock of Western Union. The entire amount of Class B stock to be received from Western Union will have a value substantially less than the aggregate liquidation preference of the preferred stock of Postal. Consequently, under its certificate of incorporation Postal's common stockholders—whose equity is deeply under water—would be entitled to receive nothing if ordinary liquidation occurred. Subject to various adjustments which do not have my immediate attention, Western Union will assume approximately $10,800,000 of Postal's liabilities. Postal's economic position is shown by its steady losses, aggregating over $13,500,000 from February 1, 1940, to May 31, 1943. These losses have been financed, in part, by advances from the Reconstruction Finance Corporation. In facing further corporate existence, two courses were open to Postal: (a) To submit to government ownership or (b) to seek some type of merger with or absorption by Western Union.

In order to complete the proposed transfer of assets to Western

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shall not be sufficient to provide payment in full of the amounts to which the holders of the Non-Cumulative Preferred Stock shall be so entitled, the amount distributable to the holders of all shares of the Non-Cumulative Preferred Stock shall be apportioned among them ratably, in proportion to the amounts to which they are respectively entitled."

The certificate of incorporation as amended provides: "(e) In the event of any liquidation, dissolution or winding up of the affairs of the Corporation, whether voluntary or involuntary, the holders of shares of the Non-Cumulative Preferred Stock shall be entitled to be paid, before any distribution or payment shall be made to the holders of the Common Stock or of any other class of stock ranking junior to the Non-Cumulative Preferred Stock, $60 per share plus all unpaid dividends thereon to the extent that the same shall be deemed to have been earned, as provided in subdivision (a) hereof, to the date of payment. In the event that at such date of payment the amount, if any, of the dividends deemed to have been earned on the shares of the Non-Cumulative Preferred Stock for the period between the dividend payment date next preceding such date of payment and such date of payment cannot be determined, dividends on the shares of Non-Cumulative Preferred Stock shall be deemed to have been earned at the full rate of $2.40 per share per annum for such period.

"*Provided, however, that notwithstanding the provisions of the next preceding paragraph in this subdivision (e) contained, if substantially all of the assets of the Corporation or of its operating subsidiaries are sold to the Western Union Telegraph Company then upon any liquidation, dissolution or winding up of the affairs of the Corporation the holders of shares of the Non-Cumulative Preferred Stock shall be entitled to receive for each share out of the assets of the Corporation (in lieu of the cash payments in said next preceding paragraph specified) one share of the Class B Stock of The Western Union Telegraph Company before any distribution or payment shall be made to the holders of shares of Common Stock; but they shall be entitled to no further or other participation in any distribution or payment.*

"After the making of such payment to the holders of the Non-Cumulative Preferred Stock, the remaining assets and funds of the Corporation shall be distributed among the holders of the Common Stock and of all other classes of stock ranking junior to the Non-Cumulative Preferred Stock according to their respective rights and shares. If, upon any such liquidation, dissolution or winding up of the affairs of the Corporation, whether voluntary or involuntary, the assets of the Corporation shall not be sufficient to provide payment in full of the amounts to which the holders of the Non-Cumulative Preferred Stock shall be so entitled, the amount distributable to the holders of all shares of the Non-Cumulative Preferred Stock shall be apportioned among them ratably, in proportion to the amounts to which they are respectively entitled." (Italics supplied.)

Union, the vote of a majority of the outstanding stock of Postal was required under the Delaware law, sec. 65. See Rev.Code of Delaware of 1935, c. 65, Sec. 2097. Postal's outstanding preferred was 256,769.9 and the number of shares of common was 1,027,076.6. Hence, if all the preferred voted in favor of the plan, it would still be necessary to obtain the affirmative vote of approximately 400,000 shares of common. In order to obtain such vote, Postal's directors determined it advisable that the preferred's rights on liquidation be modified, so as to provide that out of the 308,124 shares of Class B stock of Western Union to be received by Postal, 256,770 shares would be distributed share for share for each of Postal's preferred and the balance of the Class B—51,354 shares—would be distributed to Postal's common stockholders, which was to be in the ratio of 1/20 of a share of Class B Western Union stock for each share of common stock of Postal.

As part of the plan, Western Union would also change its present 1,045,592 shares of capital stock into an equal number of shares of Class A stock without par value, which stock would be entitled to a non-cumulative dividend of $2 per share in each year before any dividends could be paid upon the Class B stock. After such dividend payment, the Class A and Class B stock are to participate on an equal basis in any dividends. I shall not pause, at this moment, to discuss certain collateral factors which entered into the considerations for the adoption of the plan, such as the former duplication of Postal's facilities with those of Western Union, the elimination of competitive factors, the more efficient utilization of personnel and equipment, the reduction of expense, improved service to the public, or the more effective means to compete with other methods of communication.

Plaintiff here seeks, on behalf of himself and all other non-assenting shareholders,[45] to enforce the liquidating rights which he contends are secured to him by the certificate of incorporation of Postal prior to the adoption of the resolution to amend it under Sec. 26. Defendant moved to dismiss on the ground that the complaint failed to state a cause of action.

Two issues are raised by the pleadings: (1) Whether the amendment to Postal's certificate of incorporation is authorized under Sec. 26 of the Delaware Corporation Law, and (2) if Sec. 26 authorizes the present amendment whether the statute to this extent is constitutional.

II. *The Delaware Law.* The national and Delaware bars generally together with the legal literature[46] especially have been unwilling to look directly at the radiations from the Delaware opinions which disclose what reclassification acts may be accomplished under Sec. 26 of the Delaware Corporation Law.

After much contemplation I concluded this is not the occasion to

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45 In addition to plaintiff's 500 shares, several hundred other shares are opposed to the plan.

46 The Delaware decisions, as well as the decisions of other states and federal courts, involving corporate action taken under the Delaware statutes are discussed at length in Meck, Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine, 55 Harv.L.Rev. 77; Dodd, Fair and Equitable Recapitalizations, 55 Harv. L.Rev. 780; Latty, Fairness—The Focal Point in Preferred Stock Arrearage Elimination, 29 Vir.L.Rev. See, too, Note: Corporate Recapitalization By Charter Amendment, 46 Yale L.Jour. 985.

trace in limine the growth of the Delaware law in the field of corporate reclassification or rearrangement of stockholders' rights in order to show the development of a logical pattern of judicial thought on this and allied questions. Because the Delaware decisions are so crystalline in outline, I am mildly surprised there could be disagreement of interpretation as to just what may not be accomplished under the corporation statutes of that state.

Defendant's certificate of incorporation provides that, in the event of liquidation or dissolution, the holders of preferred stock are entitled to be paid $60 per share, plus all unpaid dividends (of which there are none), before any distribution is made to the holders of the common or junior stock. Sec. 26 provides that an amendment to a certificate of incorporation may alter or change "preferences" theretofore provided for a preferred stock, if the vote of a requisite majority is had. Because at common law, in the absence of agreement to the contrary, all shares of stock, by whatever name they may be known, stand upon an equal footing, preferences, being in derogation of the common law rule, must be strictly construed. Gaskill v. Gladys Belle Oil Co., 16 Del.Ch. 289, 146 A. 337; Machen, Corporations, Sec. 517. Historically, preferential rights consist generally of two classes of preferences, viz.: (1) Preferences as to dividends and (2) preferences in distribution of assets upon liquidation, or winding-up.[47]

The right of preferred to priority in distribution of assets upon liquidation is clearly a preferential right within the meaning of the Delaware statutes. In Morris v. American Public Utilities Co., 14 Del.Ch. 136, 122 A. 696, 705, there was involved the right to reduce by amendment the redemption price of preferred stock from $105 per share to $100, the par value of the shares. In holding the amendment valid, the late Chancellor Wolcott wrote: "Whether such a change may be said to be the alteration of a preference within the meaning of, and therefore authorized by, section 26 I need not pause to consider, for section 13, which authorizes the issuance of preferred stock supplies sufficient authority for the change here involved. That section provides that any or all classes of preferred stock may be made subject to redemption at such price not less than par 'as may be expressed in the certificate of incorporation *or an amendment thereof*'". The Morris case is, in principle, applicable, since an analogous provision exists in Sec. 13 (Rev.Code of Delaware of 1935, c. 65, Sec. 2045, p. 464) with respect to the rights of the holders of the preferred stock upon distribution of assets. Sec. 13, after providing that every corporation shall have the right to issue one or more classes of stock with such preferences as may be stated and expressed in the certificate of incorporation or any amendment thereto, provides that "The holders of the preferred or special stock of any class or of any series thereof shall be entitled to such rights upon the dissolution of, or upon any distribution

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[47] In Starring v. American Hair & Felt Co., 21 Del. Ch. 380, 191 A. 887, 890, affirmed 21 Del. Ch. 431, 2 A.2d 249, it was said: "It [preferred stock] is of course a stock which in relation to other classes enjoys certain defined rights and privileges. These rights and privileges are generally associated with specified dividend and liquidation priorities." See, too, Garrett v. Edge Moor Iron Co., 22 Del. Ch. 142, 194 A. 15, affirmed sub nom. Pennsylvania, etc., Co. v. Cox, 23 Del. Ch. 193, 199 A. 671.

of the assets of, the corporation as shall be stated and expressed in the Certificate of Incorporation, *or any amendment* thereto * * *." (Italics supplied.)

It plainly appears, therefore, that Sec. 13 contemplates such rights are subject to amendment under Sec. 26. As the right of the preferred stockholder here involved is a preferential right within the meaning of the Delaware Corporation Law (i.e., the stock is preferred on dissolution), I hold such right is subject to the amendment here involved under the particular language of Sec. 26. Peters v. United States Mortgage Co., 13 Del.Ch. 11, 114 A. 598.

III. *The Constitutional Question.* Plaintiff's main contention is that if Sec. 26 authorizes the action taken by Postal it is unconstitutional, because such action will result in the destruction of what plaintiff calls his "vested" or "property" rights. Obviously, the determination of this question depends upon whether one accepts or rejects plaintiff's primary postulate of what is a "vested" or "property" right.

A person buying into a Delaware business corporation does so subject to the provisions of the particular charter and the Delaware Corporation Law. Delaware law assumes such person realizes Sec. 26 provides that *preferences* may be changed by a requisite majority vote. And preferred stockholders of a Delaware corporation when they buy into the particular enterprise accordingly consent in advance that whatever their preferences may be at the time they are subject to change by vote of the proper majority. See Morris v. American Public Utilities Co., and Peters v. United States Mortgage Co., supra. This is not a harsh rule. When parties purchase preferred stock in Delaware corporations, they are charged with knowledge that Secs. 13 and 26, as well as other sections, are impliedly written into their charter, Peters v. United States Mortgage Co., supra.[48] It is one of the fundamental concepts of the Delaware law that protection is afforded against arbitrary action in the requirement that a majority of those affected by the amendment must vote in favor of it. This democratic principle, based, in reality, on a worldly or practical necessity, is that the voice of a majority must be accepted as an expression of what is best for the whole. Moreover, another concept established by the Delaware decisions is that, assuming a grant of power by statute, the action proposed by the majority is not clothed thereby with a superior sanctity vesting such power with the attributes of tyranny. The exercise of such grant is always subject to the historical processes of the court of equity to gauge whether there has been an oppressive exercise of the power granted, Allied Chem. & Dye Corp. v. Steel & Tube Co., 14 Del.Ch. 1, 11, 12, 120 A. 486. This is "fair and equitable" language. Where, as here, it is admitted there are no questions of unfairness involved, the only question remaining is one of classic constitutionality, involving only the contract clause and due process. * * *

It is clear on principle there can be no constitutional objections to

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[48] To say that in fact they have no such knowledge is to ask the courts to indulge in a judicial paternalism that would be limitless. Fixity of legal principle would then be required to give way to judge-made theory of what should constitute corporate-stockholder cricket.

the present amendment. Since the corporation is the creature of the state, and since the corporation law is a part of the corporate charter (Peters v. United States Mortgage Co., supra), it is self-evident the state has the right to reserve to itself, or a majority or more of the stockholders, the power to change the contract between the corporation and its stockholders or between its different classes of stockholders by an amendment to the charter after such contracts are made, even if a particular class of stockholders must suffer slightly. If a rationale is sought for this reservation of power, then a more cogent reason than that which exists in the case at bar would be difficult to find. Here, the public interest has a stake. We are concerned with two of the great communicating systems of this country. Duplicity of effort gone, an attendant increase in efficiency and decrease in waste will naturally make the public beneficiaries, in part, by the absorption of Postal by Western Union. Viewed against the undoubted reservation of right by the state and the public interest involved, changes in liquidating preferences seem mild.

One reason why plaintiff has misinterpreted the Keller and Consolidated Film cases is that if plaintiff is right, those cases, in effect, overruled Morris v. American Public Utilities Co., and Peters v. United States Mortgage Co., supra, because there is no difference in substance in the nature of the rights involved in the various situations. I do not think the Delaware courts intended to overrule those cases in such indirect fashion.[49] For example, in Shanik v. White Sewing Machine Corp., Del.Ch., 19 A.2d 831, a plan was not disapproved which involved an amendment specifically reducing liquidating preferences, e. g., the old preferred was reduced on dissolution from $50 to $25.[50] * * *

Plaintiff argues, however, that execution of the contract of sale of assets by Postal and Western Union on May 13, 1943, gave to preferred a present right to payment of $60 per share, and that its right to such payment on dissolution or liquidation then became a "fixed and vested right". But, the agreement of May 13, 1943, was not binding upon Postal, since by its terms it called for authorization by the vote of its stockholders. Allied Chemical & Dye Corp. v. Steel & Tube Co., supra. A sale of assets does not constitute a dissolution or necessarily call for a liquidation. Cleveland Worsted Mills Co. v. Consolidated Textile Corp., 3 Cir., 292 F. 129. Here, Postal might have continued to hold the Class B shares of stock of Western Union without distribution to its stockholders. In fact, such a course was suggested in its proxy statement which it sent to all its stockholders.

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[49] It is interesting to speculate that, in some situations, if the doctrine of the above cases has not been overruled by indirection, the result sought to be achieved in Keller v. Wilson can now be accomplished by sufficiently reducing the liquidating preferences other than the amount due for unpaid and accrued dividends by amendment under Section 26. This would not require appraisal and since the corporation has the power there can be no question of validity, Federal United v. Havender United Corp., Del.Ch., 11 A.2d 331; Shanik v. White Sewing Machine Corp., Del.Ch., 19 A.2d 831, in the absence of fraud. See Porges v. Vadsco Sales Corporation, Del. Ch., 32 A.2d 148.

[50] See footnote 42, supra, for the proposition that, perhaps, the Shanik case may not be said to have contained such a precise holding.

I conclude the execution of the May 13, 1943, contract for sale of assets to Western Union did not accelerate the preferential right of Postal's preferred stockholders to $60 a share on dissolution into a "vested right" which could not thereafter be altered by amendment under Sec. 26. * * *

Accordingly, I conclude for the reasons hereinabove mentioned that defendant's motion to dismiss has merit. A form of decree for my consideration may be submitted upon notice.

(a) Reclassification or Amendment of Charter

(For New York and Delaware Statutes, see infra, p. 1329)

NOTE

(A) New York Stock Corporation Law, §§ 36–38, provides that any stock corporation may authorize the issue of new shares of any class of stock, may classify or reclassify[51] any shares of stock, and may issue preferred shares from time to time[52] by filing a certificate stating the proposed change and its authorization by a two-thirds vote[53] of the holders of the outstanding voting shares at a stockholders' meeting held for the purpose. Any holder of preferred stock who does not vote in favor of the alteration of preferential rights of any outstanding shares, may object in writing to such alteration, demand payment for his stock and have it appraised and paid for pursuant to statute.[54]

(B) "It has been held that an amendment authorizing the issue of preferred stock is valid. Although the effect of such an amendment is to place the common stockholders in an inferior position, the results reached in these cases would seem to be sound. The ordinary corporation has implied power to mortgage, and the effect on a common stockholder of an issue of preferred stock is hardly more serious than is the effect of mortgage bonds. It would seem, however, that, if the preferred stock has voting rights, the issue ought not to be permitted to be made without giving the common stockholders preemptive rights to subscribe thereto." Dodd, Dissenting Stockholders and Amendments to Corporate Charters, 1927, 75 U. of Pa. L.Rev. 585 and 723, 732–733. See, also, Curran, Minority Stockholders and The Amendment of Corporate Charters, 1934, 32 Mich.L.Rev. 743, esp. 765 et seq.; Levy, Rights of Dissenting Stockholders to Appraisal and Payment, 1930, 15 Corn. L.Q. 420. To the effect that a corporation may amend its certificate to create cumulative prior preference stock having priority over existing preferred stock in respect of principal and dividends, see Note, 1925, 11 Corn.L.Q. 78.

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[51] Notes, 1933, 42 Yale L.J. 952; 1938, 38 Col.L.Rev. 511, deal with reclassification of outstanding stock.

[52] Cf. N.Y.Stock Corporation Law, § 11, supra, p. 223.

[53] See, also, N.Y.Stock Corporation Law, § 51, infra, p. 1121.

[54] Cf. Cal.Civil Code, §§ 362, 362a(5); Sterling, Amendments to California Corporation Laws, 1937: Readjusting Stock Structure, 1937, 26 Calif.L.Rev. 76, 76–83; Del. Rev.Code 1935, § 26 (only majority vote necessary to effect a change in share structure; no provision for appraisal and sale of shares of dissenting stockholders); Ill.Business Corporation Act 1933, §§ 52, 53, Smith-Hurd Stats. c. 48, §§ 157.52, 157.53; N.J.Rev.S.A. 14:11–1(i), 14:11–2, 14:11–4; Pa.Business Corporation Law 1933, §§ 801–809, 15 P.S.Pa. §§ 2852–801 to 2852–809. None of these statutes contain any provision for appraisal and sale to the corporation of shares of dissenting stockholders; some of them provide only for a majority vote of all the outstanding shares, some for a majority of the voting shares, and some, like New York, require a two-thirds approval of the proposed amendment.

WHEATLEY et al. v. A. I. ROOT CO. et al.

Supreme Court of Ohio, 1946. 147 Ohio St. 127, 69 N.E.2d 187.

Action by Mary Wheatley and others against the A. I. Root Co. and others to enjoin defendants from carrying out a proposed plan of recapitalization. The Court of Common Pleas found for defendants and an appeal was taken to the Court of Appeals, and the cause came before the Supreme Court upon allowance of motions to certify the record of the Court of Appeals submitted by plaintiffs and defendants.—[Editorial Statement.]

Affirmed in part and reversed in part, and cause remanded. * * *

MATTHIAS, JUDGE. The parties to this action agree that the purpose and object of the proposed "plan of recapitalization," among others, was the alteration of the original agreement made by the corporation with the preferred shareholders, which agreement, incorporated in both the articles of incorporation and the certificates of shares, provided that the holders of such preferred shares were entitled to receive dividends on such shares of five per cent per annum annually out of the surplus profits of the company for each year, in preference to all other shareholders, and that such dividends should be cumulative.

The record in this case shows that as of July 31, 1943, which date was prior to the recapitalization, the financial statement of the corporation stated the earned surplus account as follows:

Balance at August 1, 1942	$42,584.43
Balance transferred from profit and loss	52,480.96
	$95,065.39
Dividends paid cash:	
First preferred—$6.25 per share	$17,062.50
Balance at July 31, 1943	$78,002.89

The record shows also that as of July 31, 1944, after the recapitalization had been carried out, the first preferred five-per-cent cumulative shares having been canceled, and the 2,750 shares of five-per-cent noncumulative preferred shares and the 2,750 shares of class A common stock issued in place thereof, the earned surplus account stood as follows:

Balance at August 1, 1943		$ 78,002.89
Balance for the year transferred from profit and loss		31,260.65
		$109,263.54
Cash distribution and dividends:		
On first preferred—5% cumulative stock (changed under plan of recapitalization)—$11.25 per share (includes $10 special distribution under plan)	$30,543.75	

On preferred 5% noncumulative stock—$2.50 per share..........	6,787.50	$ 37,331.25
Balance at July 31, 1944		$ 71,932.29

A comparison of these financial statements clearly discloses the effect of the plan of recapitalization. As of July 31, 1943, there was in the earned surplus account the sum of $78,002.89 to which the holders of preferred shares had a preference in that their unpaid cumulative dividends were to be paid from such funds before any dividends could be declared and paid to the holders of the common shares. As of July 31, 1944, there remained in the earned-surplus account the sum of $71,932.29, but the holders of the first preferred shares no longer had a claim thereto for their cumulative unpaid dividends, for the reason that such sum became available for distribution to the holders of the common shares subject only to the requirement of payment of current dividends upon preferred shares.

To succinctly state the proposition presented: The preferred shareholders were required to accept additional shares of stock, and the common shareholders were accorded the right to the accumulated earnings.

The plan of recapitalization is alleged to have been evolved pursuant to and in conformity with the provisions of Sections 8623-14, 8623-15 and 8623-72, General Code. Counsel for the defendants concede that the effect of the proposed plan is "to adjust and eliminate undeclared cumulated dividends of $50 per share on the preferred shares and to recapitalize the company."

The general corporation laws of Ohio were revised, consolidated and codified in 1927, 112 Ohio Laws, 9; in 1929, 113 Ohio Laws, 413 extensive amendments were made; and again in 1939, 118 Ohio Laws, 177.

These statutory provisions expressly conferred upon corporations the power to make substantial amendments to their articles of incorporation, which amendments were not theretofore authorized, particularly by changes in the classes of outstanding and issued shares of stock, and provided a specific remedy by way of appraisal and ascertainment of the fair cash value of shares held by any dissenting shareholder and payment therefor upon demand. The amendment of 1939 expressly authorizes a corporation to "change any or all of the express terms and provisions or designations of issued or unissued shares of any class or series; which change, if desired, may include the discharge, adjustment or elimination of rights to accrued undeclared cumulative dividends on any such class" Section 8623-14 (3) (i), General Code.

The plan of recapitalization involved in this proceeding was proposed and effectuated after the 1939 amendment, and neither party complains of any failure to fully comply with the requirements of the statutes. The issue here presented arises out of the claim of the plaintiffs that these statutes, as amended in 1939, can have no application to their shares; that the plan of recapitalization requires a retroactive application of the terms of these statutory provisions; that

no plan is valid which affects their rights under their contract to earnings accumulated either before or subsequent to the effective date of the 1939 amendment; and that, therefore, the action of the Court of Appeals in holding that these statutes affected such rights of the plaintiff to dividends accruing after 1939 is erroneous.

On the other hand the defendants claim that the plan of recapitalization was fully authorized and that all cumulative dividends were thereby legally canceled. They further claim that the Court of Appeals erred in holding that only the cancellation of dividends accruing subsequent to 1939 is valid and lawful.

The authority granted by Section 8623-14(3) (i), General Code, is clear and unambiguous and is sufficiently broad to authorize the cancellation of dividends accruing either previous or subsequent to the effective date of that section.

It is clear that the particular effect of the consummation of the plan is to cancel the obligation of the corporation to pay to the preferred shareholders the unpaid cumulative dividends and to abolish the preferential rights of such shareholders, specified not only in their respective certificates of stock but also in the articles of incorporation under which the stock was issued. Therefore, the question of law presented is whether the provisions of the statute referred to may be applied retroactively to authorize a plan, the effect of which will be to revoke the contractual rights of preferred shareholders whose shares were subscribed for prior to the enactment of those statutes.

It is pointed out that the protective provisions of the contract involved herein are limited to cumulative dividend rights in earnings with priority over the common shares, priority rights in distribution of assets over the common shares in event of dissolution, and the right to par plus accrued dividends upon redemption. Such preferred shares are excluded from participation in the selection of the directors, and further there is no provision for a sinking fund for the redemption of the preferred shares, no restriction upon debts or encumbrances and no limitation upon the relative amounts of preferred and common shares. From these facts it is logically argued that the elimination of the cumulative-dividend provision would result in a serious impairment of the value of the shares and possibly even make them less desirable than the common. The conclusion is irresistible that the compulsory provision of the proposed plan would deprive the preferred shareholders of accrued dividends and require a sacrifice of the benefits secured to them by their contract.

If such retroactive legislation may be justified under the Constitution of Ohio, such justification must result from the application of the so-called "reserved power" provision as found in Section 2, Article XIII. This section provides as follows: "Corporations may be formed under general laws; but all such laws may, from time to time, be altered or repealed. * * * "

It is difficult to see how this specific grant of authority to alter or repeal corporation laws exceeds or differs from the power conferred upon the General Assembly by provisions of Section 1, Article II of the Constitution. Under the authority thereby conferred, the General

Assembly unquestionably has the power to alter or repeal any statute theretofore enacted by it. The power and the authority of the legislative body, however, has specific and absolute limitations under the Ohio Constitution. It is specifically provided by Section 28, Article II of the Ohio Constitution that "The general assembly shall have no power to pass retroactive laws, or laws impairing the obligation of contracts * * *."

The provision of Section 19, Article I of the Ohio Constitution precludes the taking of private property even for public purposes except as therein provided.

The preferential rights of the plaintiffs to the accrued unpaid dividends under their contract were vested and absolute as between the parties and enforceable in a court of law until the corporation, a party to the contract, undertook to abolish and eliminate such rights of the preferred shareholders to the gain and profit of the common shareholders.

The constitutional limitations upon the power of the General Assembly to pass retroactive laws or laws impairing the obligation of contracts apply most aptly and with particular force to the present situation. If Section 8623-14(3) (i), General Code, were applied to the contract of these preferred shareholders the result would be to completely abrogate their contract, deprive them of the benefit thereof and presumably secured thereby, and enrich the holders of the common shares by transferring to them the outright ownership of the accumulated earnings in which, under the terms of their contract, the preferred shareholders had vested rights. * * *

There could be no basis for the contention in this case that the statutory provisions involved herein were enacted for or in fact served any public purpose. The provisions of the proposed plan, insofar as they undertake a retroactive application of these statutory provisions and thus impair the contract of the preferred shareholders and thereby deprive them of the rights stipulated therein, are invalid.

It should be observed that no question relative to the prospective application of these statutes is presented, and, therefore, is not considered or decided.

This being a class suit as defined by Section 11257, General Code, it was properly brought by plaintiffs for themselves and on behalf of those similarly situated. See Haggerty v. Squire, Supt. of Banks, 137 Ohio St. 207, 28 N.E.2d 554, where it was held in paragraph two of the syllabus:

"Where a number of persons have separate and individual claims and rights of action against the same party, but all such claims arise from a common source and represent a like interest, the whole matter may be litigated in a single action brought by all of the claimants as co-plaintiffs, or, in case the parties are numerous making it impracticable to bring them all before the court, by one or more of them suing for himself or themselves and on behalf of the other claimants."

The Court of Appeals held that the factual situation attending the acquisition of the preferred shares differed in each case as to the time of purchase, and that as to the various shareholders, different claims

and defenses would be involved, and, therefore, the shareholders did not properly constitute a class for which a suit may be brought. However, the record shows that the parties, themselves, by stipulation in the Court of Common Pleas divided the preferred shareholders into classes in accordance with the attitude of each as to consent, acquiescence or opposition in connection with the recapitalization. The Court of Common Pleas, by reason of its dismissal of the petition of the applicants, did not consider the respective rights of these classes.

The determination of the question as to who constituted the class of shareholders "similarly situated" with the plaintiffs being undetermined, the case is remanded to the Court of Appeals for further proceedings in accordance with this opinion. In the respect indicated, the decree of the Court of Appeals is reversed and the cause remanded to that court.

Decree affirmed in part and reversed in part.

ANDERSON v. INTERNATIONAL MINERAL & CHEMICAL CORPORATION.

Court of Appeals of New York, 1946. 295 N.Y. 343, 67 N.E.2d 573.

Action by William C. Anderson, suing on behalf of himself and such other stockholders similarly situated as might choose to come in and contribute to the expense of the action, against the International Minerals & Chemical Corporation to require defendant to pay dividends on stock, for injunctive relief against paying dividends on any stock of consolidated corporation until plaintiff and others participating had been paid on their stock, and for other relief. From a judgment of the Appellate Division of the Supreme Court entered December 18, 1945, affirming by divided court, 269 App.Div. 1017, 59 N.Y.S.2d 146, a judgment of the Supreme Court in favor of defendant, entered in New York County upon a decision of the court on a trial at Special Term, Schreiber, J., dismissing the complaint on the merits, plaintiff appeals.

Affirmed.

THACHER, JUDGE. We are concerned in this case with the merger and consolidation of International Agricultural Corporation, a New York corporation, and Union Potash & Chemical Company, a Colorado corporation. These companies were consolidated pursuant to section 91 of article 8 of the New York Stock Corporation Law, Consol. Laws, c. 59, and the defendant, International Minerals & Chemical Corporation, organized under the laws of the State of New York, is the consolidated or continuing company resulting from the merger of the two constituent companies.

The plaintiff, William C. Anderson, owner and holder of 500 shares of 7% prior preference cumulative stock of International Agricultural Corporation, did not vote his stock for or against the merger and consolidation nor was he present or represented by proxy at the meeting of the shareholders of this company on March 30, 1942, when

resolutions were adopted by the vote of more than two thirds of the issued and outstanding shares of each class of stock. These resolutions authorized the consolidation and merger of the two companies upon the terms set forth in the certificate of consolidation and agreement of merger. It was provided therein that each share of the 7% prior preference cumulative stock of International Agricultural, including all accumulated and unpaid dividend arrears thereon, was converted into one share of the 4% cumulative preferred stock and three and one-half shares of the common stock of the continuing corporation. At the time of the consolidation these dividend arrears aggregated $95 per share. The holders of the original common stock were to receive for each share of the old stock held by them one fourth of one share of new common stock. Action authorizing the consolidation and merger was taken by the Union Potash & Chemical Company as permitted by and in compliance with the laws of Colorado and also in compliance with section 91 of article 8 of the New York Stock Corporation Law. The merger and consolidation were consummated by filing the certificate of consolidation with the Secretary of State of New York and by filing the agreement of merger with the Secretary of State of Colorado.

Plaintiff received notice of the special meeting, presenting the details of the proposed consolidation and merger, more than five weeks before the meeting, a follow-up notice ten days before the meeting and knew of the consolidation proceeding at all times.

On April 7, 1942, the day after the consolidation was consummated by filing certificates of consolidation with the Secretaries of State in the two States, plaintiff was requested to present his old shares for exchange for the new shares. On June 1, 1942, a dividend of a $1 per share upon the new cumulative preferred stock was declared and plaintiff was again requested to present his old stock for exchange. On June 30, 1942, plaintiff received a similar request advising him that there had been forwarded under separate cover a check in the amount of $1 per share covering the first quarterly dividend on the 4% cumulative preferred stock to which he was entitled. This check was received, indorsed and cashed for plaintiff's account.

Subdivision 7 of section 91 of article 8 of the Stock Corporation Law provides that: "Any stockholder of a domestic corporation included in such consolidation, not voting in favor thereof, may object to such consolidation and demand payment for his stock, at any time prior to the vote, * * *. The objecting stockholder or the corporation shall have the right to have such stock appraised and paid for in the manner provided, and subject to the conditions imposed by section twenty-one. * * *"

Plaintiff never made demand under these provisions of the law and did not object to the proposed consolidation until almost three months after the first dividend check on the new 4% cumulative preferred stock had been received and cashed for his account. Under date of September 22, 1942, plaintiff wrote the following letter to the defendant corporation:

"I have just returned from the country where I have been since the latter part of June. I have just learned that in my absence a check for $500.00 was mailed to me purporting to be a dividend on shares of 4% cumulative preferred stock of your corporation. I have further learned that without any knowledge on my part and without any authorization from me said check was deposited in my account.

"Please be advised that I do not own any of the shares on which the check above mentioned purports to be a dividend and I therefore return herewith my check for $500.00 to the order of your company in repayment of the amount mistakenly sent me and deposited in my account in error while I was away."

Thereafter this action commenced. The amended complaint alleges that plaintiff is the owner and holder of 500 shares of the 7% prior preference cumulative stock, acquired during the years 1931 and 1932 and held and owned by him at all times since; that at the time of the consolidation and merger there were accumulated and unpaid dividends on the 7% prior preference cumulative stock of approximately $95 a share; that under the terms of the consolidation holders of the 100,000 shares of 7% prior preference cumulative stock were to receive in place of each of their shares and the accumulated dividends thereon one share of 4% cumulative preferred stock and three and one half shares of common stock of the consolidated corporation, and that upon receipt of the new securities the right to accumulated dividends amounting to $47,500 on plaintiff's 500 shares was to be canceled and extinguished. The relief prayed for includes judgment that defendant's action was void and unenforcible as to accumulated dividends on plaintiff's shares and similar shares of others who come in and contribute to the expense of the action and that such dividends be paid to plaintiff and others participating with him in the lawsuit. Injunctive relief is also requested against paying any dividends on any stock of the consolidated corporation until plaintiff and others participating have been paid the accumulated dividends on their 7% prior preference shares of the International Agricultural Corporation shares.

Plaintiff relies upon decisions in cases involving the reclassification of shares under article 4 of the Stock Corporation Law prior to its amendment in 1943, L.1943, ch. 600, and particularly upon Davison v. Parke, Austin & Lipscomb, Inc., 285 N.Y. 500, 35 N.E.2d 618, where we held that sections 36 and 38 of that article, before their amendment, did not confer power to deprive preferred shareholders of accumulated dividends without their consent. Under those sections of the law the right of a shareholder to object to a reclassification of capital stock and demand an appraisal was quite restricted. Matter of Kinney, 279 N.Y. 423, 18 N.E.2d 645; Matter of Duer, 270 N.Y. 343, 1 N.E.2d 457; Matter of Dresser, 247 N.Y. 553, 161 N.E. 179; cf. Matter of Silberkraus, 250 N.Y. 242, 165 N.E. 279, 78 A.L.R. 1113. The reclassification provisions of the statute as then written did not contemplate or expressly provide for reclassification which deprived shareholders of accumulated dividends. The reclassification provided for, therefore, presented problems very different from the problems of reorganization

and merger which necessarily involve exchange of shares in an old company, with all their rights, for new shares with new rights in a new company. Our decision in the Davison case, supra, dealing with reclassification under the statute, before its amendment, went upon the failure of the statute to provide for a reclassification of shares which involved surrender of accumulated dividends. As a result of this decision the statute was amended to so provide.[55] * * * [Complaint dismissed.]

KELLER v. WILSON & COMPANY et al.[56]

Supreme Court of Delaware, 1936. 21 Del.Ch. 391, 190 A. 115.

Suit by Joseph Keller and another, on behalf of themselves and all other stockholders of defendant Wilson & Company, Incorporated, similarly situated, against Wilson & Company, Incorporated. From an order sustaining a demurrer to the bill of complaint and from a decree (180 A. 584) dismissing the bill of complaint, the complainants appeal.

Order and bill reversed, and cause remanded, with directions.

The bill of complaint was filed by the complainants on behalf of themselves and all other stockholders of Wilson & Co., Inc., similarly situated. It averred that the respondent was incorporated in Delaware on November 30, 1925. By an amendment of its charter on February 24, 1926, its authorized capital stock consisted of 500,000 shares of 7% cumulative Preferred Stock, each of the par value of $100; 500,000 shares of Class A. Stock of no par value; and 1,500,000 shares of Common Stock, of no par value.

By the amendment the Class A. Stock was made, in effect, a second preferred stock. It was entitled to noncumulative dividends at $5.00 per share up to October 31, 1930, and thereafter to cumulative dividends at the same rate, before dividends payable on the common stock; was entitled in liquidation to $75.00 per share plus accrued unpaid dividends, after full payment on the 7% Cumulative Preferred Stock, before distribution to the Common Stock; was callable at $75.00 per share plus accrued unpaid dividends; and was convertible at the option of the holder into Common Stock share for share.

On February 1, 1935, there were issued and outstanding 227,223 shares of the preferred stock, 315,205 shares of the Class A. stock, and 434,466 shares of the common stock; and on that date there were accumulated and unpaid dividends on the preferred stock amounting to $26.25 per share or a total of $5,965,260 on the outstanding shares, and accumulated and unpaid dividends on the Class A. Stock, amounting to $21.25 per share, or a total of $6,636,265 on the shares issued.

On December 14, 1934, the board of directors voted to submit to the stockholders a plan of recapitalization by which it was proposed to exchange the 7% cumulative preferred stock for a new 6% cumulative preferred stock of no par value, on the basis of 1.4292 shares of the

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[55] Remainder of opinion appears, infra p. 664.

[56] Though not expressly overruled, can it be said that this decision is still law in Delaware in view of the subsequent cases?

new stock for each share of the old; and to cancel the Class A. Stock and all dividends accrued thereon, the holders of said stock to receive in exchange 5 shares of common stock for one share of Class A. Stock. * * *

LAYTON, CHIEF JUSTICE, delivering the opinion of the Court:

The question presented is concerned, generally, with the nature and extent of the right of a holder of cumulative preferred stock in a going corporation, as to which dividends have accrued through lapse of time. Specifically, the questions to be determined arise under the amendment of section 26 of the General Corporation Law (Delaware Laws, vol. 38, ch. 91, § 3) and the questions are, first, whether the State, under its reserved power may authorize a corporation created by it at a time when the law, as then existing, did not permit the abrogation of dividends on cumulative preferred stock accrued through passage of time, to abolish such dividends by virtue of a statute passed after the creation of the corporation and the issuance of such stock; and, second, conceding the power of the State to enact such law, whether the statute should be construed to operate retrospectively.

It is not contended by the complainants that preferential rights attached to such stock may not be changed in future, but it is submitted that dividends accrued by lapse of time on the stock must be paid before any dividends may be paid lawfully to the holders of the common stock, for the reason that the rights of the dissenting holders of Class A. Stock are vested, and that the amendatory statute, if construed so as to confer the power of annulment upon a majority of the stockholders by appropriate charter amendment, is repugnant to State and Federal constitutional prohibitions against impairment of contractual obligation and deprivation of property without due process of law (Const.Del. art. 1, § 7; Const.U.S. art. 1, § 10; Amend. 14).

By this contention the state of the law existing at the time of the birth of the corporation and the issuance of the stock is held to control, and, therefore, the rights of the shareholders are fixed, or as it is said, vested, in the sense and to the extent that dividends accrued by lapse of time must be paid before distribution to the common shares.

The defendant insists that the state of the law existing at the time of the corporate action complained of must determine the rights incident to the stock for the reason that the State has reserved the power of amendment, and all amendatory statutes are declared to be a part of the charter.

By this contention the right of a holder of cumulative preferred stock, as to which dividends have accrued through lapse of time is not fixed or vested, except in a defeasible sense.

Modern corporation laws, very generally, contain provisions conferring upon the majority, or some other fraction, of the shareholders the right to amend the articles of incorporation so as to affect intracorporate rights, and the increasing latitude of this power has caused serious thought and comment. * * *

In the instant case the question was stated to be the narrow one, "whether it was in the power of the Legislature by way of amend-

ment of the act, to enlarge the scope of the subjects which corporations theretofore existing might themselves alter by self-amendment of their own charters, so as to effect changes which, when the corporations were created, they could not effectuate against the will of an objecting stockholder."

The question, as put, may not be answered categorically. The answer must depend upon the extent of the enlargement of the "scope of subjects," and the nature and character of the right affected. A vested right may not be destroyed. Therefore, the question to be determined is, what is the character of the right of a holder of cumulative preferred stock in a going concern as to which stock dividends have accrued through lapse of time? Is the right, in a real sense, a vested right, or is it a defeasible right, subject to destruction by corporate action under subsequent legislation?

It is difficult to define the term "vested right" with exactness; but, generally speaking, a vested right is property, as tangible things are, when it springs from contract or the principles of the common law. 2 Sutherland Stat.Cons. (2d Ed.) § 671. Judge Cooley observes that the term, vested right, "in its application as a shield of protection is not used in any narrow or technical sense, or as importing a power of legal control merely, but rather as implying a vested interest which it is right and equitable that the government should recognize and protect, and of which the individual could not be deprived without injustice." 2 Cooley Cons.Lim. (8th Ed.) 745. * * *

The right of a holder of cumulative preferred stock, issued at a time when the law did not permit of the cancellation of accrued and unpaid dividends against the consent of the holder, to such dividends, is, and ought to be regarded as a substantial right. It may reasonably be supposed that one who invests his money in cumulative preferred stock relies largely upon the right to receive the stipulated dividends at some time. Speaking generally, the investor seeks certainty as against a speculative rise in price. The right to such dividends gives value to the stock, easily recognizable even during periods when the dividends are not paid. As the right is an inducement to buy, so oftentimes is it an inducement to retain. To say that cumulative dividends can not be paid where there are no profits at hand from which to pay them is not to say that they do not accrue under the contract; and unless the corporate surplus and the financial condition of the corporation are such that it would be an abuse of discretion on the part of the management not to declare and pay a dividend on cumulative preferred stock, there seems to be no more reason to view the right of the shareholder as vested than in the case where no surplus exists at all, for in either situation the shareholder has no immediate assertable right, nor may he ever have such right.

If, as this Court reasoned in the Penington Case, that the right to have paid at some future time the accumulation of dividends on preferred stock, was, as between the shareholders, a fixed and vested right, having the nature and character of a debt, postponable in enjoyment until the creation of a fund from which payment legally could be made, it is difficult to perceive the justice of permitting the cor-

poration to destroy the opportunity to create the fund by action under a subsequent amendment to the law which, when the corporation was formed and the stock issued, did not permit of such destruction.

It may be conceded, as a general proposition, that the State, as a matter of public policy, is concerned in the welfare of its corporate creatures to the end that they may have reasonable powers wherewith to advance their interests by permitting adequate financing. It may also be conceded that there has been an increasing departure from the conception which formerly prevailed when the right of individual veto in matters of corporate government operated as a dangerous obstruction to proper functioning. But in determining whether the rights of the complainants herein are such as ought to be regarded as property rights, all aspects of the question must be considered to ascertain what is conducive to the best interests of society. The State is concerned also with the welfare of those who invest their money, the very essence of generation, in corporate enterprises. Some measure of protection should be accorded them. While many interrelations of the State, the corporation, and the shareholders may be changed, there is a limit beyond which the State may not go. Property rights may not be destroyed; and when the nature and character of the right of a holder of cumulative preferred stock to unpaid dividends, which have accrued thereon through passage of time, is examined in a case where that right was accorded protection when the corporation was formed and the stock was issued, a just public policy, which seeks the equal and impartial protection of the interests of all, demands that the right be regarded as a vested right of property secured against destruction by the Federal and State Constitutions.

We are of opinion, therefore, that the amendment of the corporate charter, in so far as it assumed to destroy the rights of the complainants to dividends accrued upon their stock up to the time of the accomplishment of the amendment, is null and void. Accordingly, the arrears of such dividends accumulated upon their stock must be paid to them before distribution may be made to the holders of the common stock.

Quite apart from the constitutional question involved, the same conclusion must be reached.

Section 26 of the General Corporation Law is the section authorizing amendments of corporate charters. It authorizes nothing more than it purports to authorize, the amendment of charters. The cancellation of cumulative dividends already accrued through passage of time is not an amendment of a charter. It is the destruction of a right in the nature of a debt, a matter not within the purview of the section. The cancellation of the right to such dividends is foreign to the design and purpose of the section. The effect of the charter amendment, in so far as it concerns the status of the shares and the rights of the owners, speaking from the time of its accomplishment, is not denied by the complainants; but there is nothing in the language of the section, as amended, which compels a retrospective operation. The rights of cumulative preferred shareholders to the

stipulated dividends accrue to them by virtue of the contract. That right exists and persists. When the necessary corporate action, under the amended statute conferring the power is taken, the status of the shares may be changed, and the right thereafter to claim the dividends as originally stipulated may be cancelled, but the amended statute under the general rule of construction, ought not to have a retroactive effect. * * *

It is contended by the appellee that the defendant, in altering its capital structure, merely exercised an amendatory power which the complainants, when they accepted their stock, voluntarily stipulated it might exercise. This contention is based upon the third paragraph of the certificate of incorporation which, in part, reads,

"It is also the intention that said clauses be construed as powers as well as objects and purposes; and, generally that the Corporation shall be authorized to exercise all other powers, rights and privileges granted by the aforesaid Act entitled 'An Act providing a General Corporation Law,' approved March 10, 1899, to corporations of the character of the Corporation, and all powers conferred upon such corporations by the then existing laws of the State of Delaware, in so far as not in conflict therewith, or which may be conferred by all acts heretofore or hereafter amendatory of said Act of March 10, 1899, or of said laws, or supplemental thereto; but the enumeration herein of certain powers is not intended to be exclusive of, or a waiver of, any of the powers, rights or privileges granted or conferred by said Act of March 10, 1899, or of the laws of said State now or hereafter in force. * * *"

This is language of the most general character. On its face it would seem not to purport to affect the contractual relations between the corporation and its stockholders, or the contract of the stockholders inter sese, but only the powers and objects of the corporation. There is no reference to stockholders at all, and it is impossible to view the provision of the corporate charter, under which the stock was issued, as constituting an express or implied assent by purchasers of stock to every corporate action under subsequent amendments of the general law resulting in the cancellation of all contractual rights. Although the Chancellor regarded the provision as similar in substance, though not in terms, to the provision of the charter in the Davis Case, and while we express no opinion upon the correctness of his conclusion as rested upon the provision of the charter there before him, we think the provisions here are quite dissimilar. In that case the provision was,

"This corporation reserves the right to amend, alter, change or repeal any provision contained in this certificate of incorporation in the manner now or hereafter prescribed by statute, and all rights conferred on stockholders herein, are granted subject to this reservation."

The defendant contends also that the complainants have no vested right to the dividends accumulated by time and unpaid for the reason that when section 26 was amended in 1927, the dividends upon Class A stock were not cumulative. It is a sufficient answer to this contention that the power conferred by section 26, as amended in 1927,

was but a permissive power. From October 31, 1930, the stock was entitled to cumulative dividends. The dividends accumulated in accordance with the provisions of the charter under which the stock was issued. The amendment of 1927 granted a power only. It might never have been exercised. If exercised, it cannot destroy rights already vested.

Finally, the defendant urges that the complainants have not pleaded the unconstitutionality of section 26, as amended, and cannot now rest their case on that ground. The bill of complaint alleges that the amendment to the charter, filed on February 23, 1935, is null and void in so far as it fails to provide for the payment of cumulative dividends on Class A stock. It also charges that the payment of dividends, declared by the defendant on February 26, 1935, to holders of common stock without paying or providing for the payment of the accrued dividends on their Class A stock is destructive of their rights. These allegations are sufficient to raise the constitutional question. The Chancellor, undoubtedly, passed upon it. There is no merit in this contention.

The order of the Chancellor sustaining the demurrer to the bill of complaint, and his decree dismissing the bill are reversed, and the cause is remanded to the Court of Chancery for such further proceedings and orders which, in conformity herewith, may be necessary.

BAILEY et al. v. TUBIZE RAYON CORPORATION.

District Court of the United States, D. Delaware, 1944. 56 F.Supp. 418.

Action by Frank Bailey and others against Tubize Rayon Corporation to enjoin defendant from enforcing an amendment to defendant's certificate of incorporation, which changed Class A and common stock into a single class of new common stock.

Complaint dismissed.

LEAHY, District Judge. Holders of an aggregate of 1137 shares of Non-Cumulative Class A $1 seek to enjoin the defendant from enforcing as to them an amendment to defendant's certificate of incorporation, adopted under Sec. 26 of the Delaware Corporation Law, Rev. Code 1935, § 2058, as amended by 43 Del. Laws, c. 132, § 5, which changed its Class A and Common stock into a single class of new common stock. The present action was commenced after the amendment had become effective. No temporary injunction was sought. The matter is here on pleadings, testimony and oral argument.

Plaintiffs' action is predicated upon two primary contentions: (1) That the reclassification effected by the amendment was unfair to plaintiffs and (2) that the amendment was accomplished by a group of stockholders who owned a majority of the Class A and Common stock and who acted for their own benefit, in breach of their fiduciary obligations to the minority. Plaintiffs do not contend that defendant lacked the power to effect the amendment or that there was a failure to comply with the Delaware Statute. Before discussing the contentions, a reference must be had to the facts.

Prior to the amendment, defendant had outstanding $4,465,000 principal amount of Fifteen Year Sinking Fund Bonds, 24,395 shares of 7% Preferred Stock $100 par, 138,814 4/7 shares of Class A $1 par,[57] including 523 6/7 shares held in the treasury, and 300,050 shares of Common $1 par, including 636 3/4 shares held in the treasury. Capital structure and asset situation of defendant appears from its balance sheet as of September 30, 1943, which is set forth in the margin.[58]

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57 Plaintiffs advance the argument that this Class A stock really had an effective par of $100, or that it was $100 stock, because it had a preferential right to $100 per share on liquidation and was entitled to a $7 non-cumulative dividend. The Class A stock was also redeemable at $105. While I agree with this particular contention of plaintiff, for reasons hereinafter stated, I do not believe that it is of sufficient importance to militate against the fairness of the plan.

58 TUBIZE RAYON CORPORATION BALANCE SHEET, SEPTEMBER 30, 1943 ASSETS

Current Assets:	
Cash on hand and demand deposits	$ 4,722,266.75
Cash on deposit for dividends	180,744.62
U. S. Government securities and accrued interest	4,011,785.69
Trade acceptances receivable	117,355.10
Accounts Receivable:	
Customers (less reserve for doubtful accounts—1943, $68,852.14)	971,216.75
Other (including royalties receivable—1943, $40,637.71)	93,334.13
Inventories (at cost, which is not in excess of market):	
Finished goods	193,974.32
Greige goods and work in process	705,535.54
Materials and supplies	1,222,270.24
Total Current Assets	$12,218,483.14
Accounts Receivable—U. S. Government post-war refund of excess profits tax	$ 354,435.79
Property, Less Reserves for Depreciation:	
Land	$ 800,672.30
Buildings	5,797,800.55
Machinery and equipment	12,218,271.42
Uncompleted additions	199,252.15
Other fixed assets	218,328.25
	$19,234,324.67
Less: Reserve for depreciation	10,192,797.36
	$ 9,041,527.31
Patents, Licenses and Other Intangibles	$ 7,501.00
Deferred Charges:	
Unexpired insurance premiums	$ 204,304.14
Other	119,227.30
Total Deferred Charges	$ 323,531.44
Total	$21,945,478.68

LIABILITIES

Current Liabilities:	
Accounts payable:	
Trade creditors	$ 497,204.24
Other	82,890.62
Dividends payable	180,768.25
Accrued liabilities:	
Taxes:	
Federal—current year:	
Normal income and surtax	491,329.95

The Class A stock entitled holders thereof to non-cumulative dividends, when and as declared by the board of directors of the defendant, at the rate of $7 per share per annum before any dividends could be paid on the Common stock. While Class A was also entitled to $100 per share on liquidation in priority to the Common stock, it and Common stock had a par value of $1 each and entitled the holders thereof to one vote per share at all stockholders' meetings. The reclassification amendment changed the shares of these two classes of stock into 705,282 shares of new Common stock, including 2,414 treasury shares, of which the Class A stockholders were given 78.7% and the Common stockholders 21.3% or, stating it in another way, the holder of one share of Class A stock received eight times as much new Common stock as the holder of one share of old Common stock—each share of Class A stock was changed into four shares of new Common stock and each share of old Common stock was changed into one-half share of new Common stock. Plaintiffs contend that the reclassification amendment was unfair because the old Common stock had merely a token value and the old Common stockholders were entitled to no substantial recognition in the reclassification. True, prior to the amendment the Class A stock had an asset value of $71.85 per share, and the old Common was under water to the ex-

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Excess profits (less current reduction due to debt retirement: 1943 $110,000,000)	1,855,319.78
Declared value excess profits	....
State income	44,050.27
Federal and State income and excess profits—Prior years	1,367,974.04
Federal and State (other than income)	196,486.30
Interest:	
On debentures	65,114.55
Other	....
Salaries and wages	64,229.76
Other	47,290.55
Total current liabilities	$ 4,842,658.31
Reserve for Contingencies	$ 257,486.12
Funded Debt—3½% Sinking Fund Debentures, due November 1, 1956 (sinking fund payments due within one year from September 30, 1943—$380,000.00)	$ 4,465,000.00
Capital Stock:	
7% Cumulative Preferred—authorized, 50,000 shares of $100 each; preference on liquidation, $110 a share plus accrued dividends; issued, 24,395 shares	$ 2,439,500.00
$7 Non-cumulative Convertible Class A—authorized 175,000 shares of $1 each; preference on liquidation (subordinate to Preferred Stock) $100 a share; issued—1943, 138,814 4/7 less 523 6/7 shares in Treasury	$ 138,290.42
Common—authorized, 700,000 shares of $1 each; issued, 300,050 shares, less 636¾ shares in Treasury	$ 299,413.50
Total Capital Stock	$ 2,877,203.92
Surplus:	
Capital and paid-in	$ 5,120,193.68
Earned	4,382,936.65
Total surplus	$ 9,503,130.33
Total	$21,945,478.68

tent of $12.96 per share. Subsequent to the amendment the new Common had an asset value of $14.14 per share. The question for determination is, therefore, whether on the basis of defendant's business, assets and earnings, the respective rights of the holders of the two classes of stock, and the market value of the two classes the amendment was fair.

Manifestly, on an asset basis the Common stock was under water. I shall not pause to discuss much of the statistical data offered at the trial; but I wish to state that it was of great help to me when I came to study the case, and counsel are to be commended for preparing for the court's benefit the lucid tables and diagrammatic charts symbolizing the corporate and financial factors called into action.

1. *Fairness of the Plan.* Defendant is engaged in the manufacture of rayon yarn and of knitted fabrics made therefrom. Since 1936 defendant has expended approximately $10,000,000 for plant expansion resulting in increased capacity of its plants of approximately 150%. There was much testimony that the manufacture of rayon is a growth industry. The management of defendant, according to the testimony, made an exhaustive study of the post-war prospects for the industry and developed plans for further increase of defendant's productive capacity. The reason given for the amendment is that the possible post-war expansion program could be more easily effectuated if defendant's capital structure were first simplified. This is clearly an adequate business reason for the amendment, irrespective of whether the post-war expectations of the directors are ever realized. The directors are endeavoring to prepare defendant to take advantage of any post-war expansion opportunities which may arise. But, the reasons for the amendment or the business necessity behind it are not matters for judicial determination. Allied Chemical & Dye Corp. v. Steel & Tube Co., 14 Del.Ch. 1, 120 A. 486; Cole v. National Cash Credit Association, 18 Del.Ch. 47, 156 A. 183; MacFarlane v. North American Cement Corp., 16 Del.Ch. 172, 157 A. 396; MacCrone v. American Capital Corp., D.C. Del., 51 F.Supp. 462, 463. Yet, in passing, it seems to me the amendment was planned with constructive intent.

Where a majority of the stockholders and directors of a Delaware corporation, acting in good faith, speak for the corporation by taking action under appropriate statutory and charter provisions, a presumption of fairness arises in favor of such action. Under the Delaware decisional and statutory law an amendment will not be condemned unless it is so unfair as to amount to constructive fraud. Allied Chemical & Dye Corp. v. Steel & Tube Co., 14 Del.Ch. 1, 120 A. 486; Cole v. National Cash Credit Association, 18 Del.Ch. 47, 156 A. 183; MacFarlane v. North American Cement Corp., 16 Del.Ch. 172, 157 A. 396; Porges v. Vadsco Sales Corp., Del.Ch., 32 A.2d 148. Clearly, the plan sub judice would not be condemned under the Delaware decisional law. I prefer, however, in this case to leave the limits of the "gross unfairness" or "constructive fraud" tests as fixed by the Delaware decisions and look at the facts of the case before me to see if the amendment is fair in the light of the practical adjustments inherent in this particular transaction. Cf. MacCrone v. American Capital Corp., D.C.Del., 51 F.

Supp. 462, 466; Barrett v. Denver Tramway Corp., D.C.Del., 53 F.Supp. 198.[59] Unless the act of the majority of the directors and stockholders is so palpably unfair as to afford no basis for a difference of opinion among reasonable men, the court should not substitute its judgment for that of the stockholders and directors. I think the amendment meets any independent test of fairness.

It is plaintiffs' theory that the right to $100 in liquidation is deemed to have matured as a result of the amendment. This theory has been rejected in this court and in this circuit. Goldman v. Postal Telegraph, Inc., D.C.Del., 52 F.Supp. 763; Hottenstein et al. v. York Ice Machinery Corporation, D.C.Del., 45 F.Supp. 436, affirmed, 3 Cir., 136 F.2d 944. Cf. In re United Light & Power Co., D.C.Del., 51 F.Supp. 217, affirmed In re Securities and Exchange Commission, 3 Cir., 142 F.2d 411. The rule in this circuit is clear that the preferential right of the Class A stockholders to receive $100 in liquidation gives them no present interest in any portion of the defendant's assets. That right would arise only upon the liquidation of the defendant and, since defendant is engaged in a profitable going business, it is impossible to foresee ultimate liquidation values of the company.

Consideration of the factors usual in testing a plan will show that the amendment was fair to the Class A stockholders.

(a) The amendment was fair in the treatment of the interests of the Class A stockholders in the assets of the defendant. The defendant's balance sheet as of September 30, 1943, shows that it had a total surplus of $9,503,130. The only right which the Class A stock had to such surplus was the right at some indefinite future time to receive $100 per share on liquidation. But this right is contingent upon liquidation. Plaintiffs ignore the fact that a great portion of the assets which they now claim could have been declared as dividends to the old Common. Clearly, the Class A stockholders, prior to the amendment, could not claim any portion of the defendant's surplus by reason of the fact that all of the earnings available for dividends on the Class A stock up to $7.00 per share had not been declared and paid to them as dividends. Under the rule of Wabash R. Co. et al. v. Barclay et al., 280 U.S. 197, 50 S.Ct. 106, 74 L.Ed. 368, 67 A.L.R. 762, where earnings available in any year for dividends on the Class A stock are not paid but are plowed back into the business "the right for that year was gone" and the Class A stockholders would not be entitled thereafter to assert a claim in respect to such unpaid dividends. Prior to actual liquidation, the right of the Class A stockholders to the $9,503,-130 of defendant's surplus is no better than the claim which the old Common stockholders had therein.

59 In Barrett v. Denver Tramway Corp. I specifically sought instructions from the Circuit Court whether the district judge in passing on the question of fairness of a reclassification or recapitalization plan was bound under Erie R. Co. v. Tompkins, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188, 114 A.L.R. 1487, to apply state law or whether the lower federal court might apply its own independent test as to "fairness". On the date of the opinion in the case at bar, the Circuit Court has not as yet filed its decision in the Barrett case. I am, therefore, following the same course I took in MacCrone v. American Capital Corp., i. e., applying first the litmus of the Delaware decisions, followed by an independent "federal" examination of the plan to test the question of fairness.

Another test shows the Class A stockholders were fairly treated from the standpoint of their interest in defendant's assets. The defendant's assets may properly be measured by capitalizing earnings. There was offered in evidence a calculation of the probable post-war income of the defendant. The average annual income for the years 1939–1941, for example, after providing for preferred stock dividends and all other prior charges, was $1,137,532. Class A stockholders receiving 78.7% of the new Common stock would, therefore, be entitled after the amendment to 78.7% of these earnings, or $895,237. Capitalizing this sum at 6% will yield a value of $14,920,628, which, compared with $13,881,429, discloses more than $100 per share and more than the aggregate par value of all the Class A shares, assuming that they had an actual par value of $100 per share. Thus, on the basis of prospective earnings, it is apparent that plaintiffs were fully compensated for their former interest in defendant's assets. This is one of the methods applied in this circuit in Hottenstein et al. v. York Ice Machinery Corp., D.C.Del., 45 F.Supp. 436, affirmed, 3 Cir., 136 F.2d 944. That case involved the fairness of the treatment of a class of 7% Cumulative Preferred stock in a merger. On the basis of the Ice Company's balance sheet, the common stock was under water. The district court, nevertheless, found that the merger which gave something to the common was fair to the preferred stockholders. At page 438 of 45 F.Supp., Judge Watson said:

"The question of fairness here involved relates only to the distribution of the stock of the resulting corporation as between the preferred and common stockholders of the defendant. The value of the preferred stock, if the common stock has any value, is approximately $10,000,000 including accumulated dividends. Therefore, if the value of the interest which the preferred stockholders receive under the plan of merger is as much or more than $10,000,000, it certainly is not so grossly unfair as to shock the conscience of the court. And, insofar as the interest given to the preferred stockholders has less than that value, the plan approaches the point at which it must be deemed so unfair that the merger should be enjoined.

"* * * Neither side offered testimony as to the probable future earnings of the company. The evidence received dealt only with the past earnings of the company up to September 30, 1941. While the past earnings of a corporation are ordinarily of considerable value in estimating probable future earnings, in the present case they are insufficient to form the basis of anything but the wildest guess as to the probable future earnings. The amount of income available for stock dividends has varied as much as a million dollars in the ten years prior to September 30, 1940, and over that period the corporation suffered an operating loss of approximately $150,000. On the other hand, the evidence also reveals that the defendant had an income subject to sinking fund arrearages, available for dividends in the year 1941 of between $800,000 and $1,200,000. Under the plan of merger, the preferred stockholders receive eighty-three and two-tenths per cent. (83.2%) of the stock of the resulting corporation. Therefore, if the lesser figure for 1941 were considered as an approximation of the

probable future earnings of the company, there would be available for dividends on eighty-three and two-tenths per cent. (83.2%) of the stock the sum of $665,600, or six per cent. on approximately $11,000,000.00. Thus, again, the evidence received fails to establish that the plan of merger is unfair."

It is clear, then, on asset basis the amendment will meet any reasonable test of fairness.

(b) The market values of the shares of the two classes sustain the percentages upon which the amendment was based. During practically the entire period from June, 1932, when the Class A stock and the old Common stock were originally issued, down to the date of the amendment, the market value of the shares of these two classes on the New York Curb Exchange stood in the ratio of one or more for the old Common to eight for the Class A. Since these shares were traded upon the free exchange their price is a good indication of what investors thought was the relative value of the two classes of stock.[60] This is especially significant since the stated ratio existed long before there was any thought of the present amendment.

(c) The amendment treated the Class A stockholders fairly from the standpoint of defendant's earnings. I think that in appraising the relative values of two classes of stock in a going concern, earnings are a matter of much importance. Cf. In re United Light & Power Co. D. C.Del., 51 F.Supp. 217, affirmed In re Securities and Exchange Commission, 3 Cir., 142 F.2d 411. The recent earnings of defendant would divide between Class A and Common stock on a per share basis after giving the Class A their full $7 per annum when earned, the ratio of approximately eight to one. Plaintiffs contend, however, that the recent earnings were unusually good and that the recent years are the only years in which the ratio did hold good. True, the ratio did hold good only in recent years, but it must be remembered that the company in 1936 commenced a major expansion program which cost approximately $10,000,000 and, consequently, the earnings of recent years are the only ones which reflect this expansion program. In view of this fact and the anticipated post-war expansion, it is reasonable to take only the recent years in considering the earnings of the company. Upon the basis of recent earnings and reasonable prospective earnings the amendment is fair to the Class A stockholders.

There was much evidence offered relative to the future of the rayon industry in the United States. There is some agreement and I think the testimony supports the conclusion that the rayon industry is a growing industry in the sense that production and consumption will continue to increase in the post-war period. Plaintiffs, however, offered much testimony to indicate that productive capacity would be so great that there would probably be a recurrence of the price war which existed in 1938 and that while production and consumption might expand, profits would tend to decline. This may prove to be the case, but I do not think that plaintiffs have met the burden of proof (which is on them) that such will be the fact. How far plaintiffs'

[60] In Geller v. Transamerica Corp., D.C.Del., 53 F.Supp. 625, 630, I discussed more fully the signifiance of prices of stocks listed on the New York Curb Exchange.

proof falls short of sustaining their burden is made clear by the following illustration: Prior to the war Italy, Japan, the Netherlands, France and Germany in the order named, were the chief rayon exporting countries. It is quite apparent that the enemy countries, where so much fighting is going on, will not be able to immediately regain their prewar competitive position after the termination of hostilities; and it may be that the peace sanctions imposed on certain of those countries will withdraw them as competitors or, at least, greatly weaken their position in world markets.

(d) On the basis of various intangible factors the amendment treated the Class A stockholders fairly. Evidence offered by defendant (which I accept) shows that upon a consideration of certain intangible factors the directors were justified in allocating 21% interest in the new Common to the holders of the old Common stock. The most important intangible factor was the surrender by the old Common stockholders of voting control. Plaintiffs claim that because a certain group owned both Common and Class A stock this was not, in fact, a surrender of voting control. This argument is beside the mark for the particular identity or community of holdings is unimportant. The important thing is that the Common stock, as such, gave up its voting control; that is a thing of value. Cf. Maddock et al. v. Vorclone Corp., 17 Del.Ch. 39, 43, 147 A. 255, 256.

I, conclude, therefore, that the amendment was fair to the Class A stockholders.

2. The members of the board of directors of defendant held or controlled an aggregate of 50,550 shares of old Common stock, or 17% of the class outstanding, and 19,707 shares of Class A stock, or 14% of the class outstanding. After the amendment these directors now own or control 104,103 shares of new Common stock, or 15% of the class outstanding. Plaintiffs argue that these holdings constitute a practical voting control of defendant. Since I am of the opinion that the amendment is fair to the Class A stockholders, the question of "improper control" becomes moot. But, since plaintiffs made so much of this point, I shall pause to consider it. It is true that there was, in fact, an identity of holdings in both Class A and old Common stock among this group of shareholders. Plaintiffs contend, as I understand the argument, that this is a fact to be considered in every case in determining whether a plan or an amendment is fair. I do not understand plaintiffs to contend that this fact per se would make an otherwise fair amendment unfair, but merely that it is a circumstance to be considered in passing on fairness. If directors or stockholders of a corporation, by appropriate action, have the power to effect a particular change, their motive for doing so is not a relevant consideration in determining the question of objective fairness. Cf. Gans v. Delaware Terminal Corp., 23 Del.Ch. 69, 2 A.2d 154, and MacCrone v. American Capital Corp., D.C.Del., 51 F.Supp. 462.

I am accordingly of the opinion that the complaint should be dismissed. Separate findings of fact and conclusions of law have been filed.

BARRETT et al. v. DENVER TRAMWAY CORPORATION.

Circuit Court of Appeals of the United States, Third Circuit, 1944. 146 F.2d 701.

Suit by W. Stanley Barrett and others against Denver Tramway Corporation to determine validity of reclassification plan of a solvent Delaware corporation involving alteration of rights of preferred stock. From a decree dismissing the complaint, 53 F.Supp. 198, plaintiffs appeal.

Affirmed.

McLAUGHLIN, CIRCUIT JUDGE. This matter arises out of the recapitalization of a Delaware corporation which eliminated accrued dividends on its old preferred shares. Suit was brought by preferred stockholders who attacked the then proposed plan as unfair. Diversity of citizenship is the basis of federal jurisdiction. The District Court dismissed their complaint. * * *

The one point on the merits of this appeal is whether the plan was fair to the preferred stockholders. This is a diversity case with a question of substantive right involved. Under the facts here, Delaware law controls the issue and it is our duty, as it was the duty of the trial court, to ascertain and apply the law of that State. [Citing cases] * * *

The Denver Tramway Corporation, which operates the public transportation system in Denver, Colorado, was incorporated under the Delaware Corporation Act in 1925 following a federal receivership reorganization. Its certificate of incorporation provided, inter alia: "The holders of preferred stock shall be entitled to receive out of the surplus or net profits of the corporation * * * dividends * * *" This limitation in regard to the funds out of which preferred dividends could be paid was in keeping with the law as it then existed in Delaware.[61] In 1927 the statute was changed in such a way as to empower the directors of a corporation to declare and pay dividends on shares of capital stock out of net assets in excess of capital or current net profits, subject to any restrictions in the corporate charter.[62]

[61] Revised Code of Delaware of 1915, Ch. 65, Sec. 34 (§ 1948):

"Dividends; Reserves:—The Directors of every corporation created under this Chapter shall have power, after reserving over and above its capital stock paid in, such sum, if any, as shall have been fixed by the stockholders, to declare a dividend among its stockholders of the whole of its accumulated profits, in excess of the amount so reserved, and pay the same to such stockholders on demand; provided, that the corporation may, in its certificate of incorporation, or in its by-laws, give the Directors power to fix the amount to be reserved."

Revised Code of Delaware of 1915, Ch. 65, Sec. 35 (§ 1949):

"Dividends; How Declared and Paid; Violations of Section; Penalty; Exoneration from Liability:—No corporation created under the provisions of this Chapter, nor the directors thereof, shall make dividends except from the surplus or net profits arising from its business. * * *"

[62] Section 34 (§ 2066) Revised Code now provides:

"Dividends; Reserves:—The directors of every corporation created under this Chapter, subject to any restrictions contained in its Certificate of Incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of its capital as computed in accordance with the provisions of Sections 14, 26, 27 and 28 of this chapter, or (b) in case there shall be no such excess, out of its net profits for the fiscal year then current

In September, 1943, when the plan under consideration was proposed, defendant corporation had outstanding 104,412 shares of cumulative preferred of a par value of $100 and 61,240 shares of common, without par, representing capital of $10,441,200 and $7,670,576.58 respectively.

Preferred enjoyed the usual privileges over common:

(a) Though both preferred and common had full voting power, this passed exclusively to preferred whenever preferred dividends were in arrears in excess of ¼ of 1% for one year or more.

(b) Preferred was entitled to dividends of 7% per annum on the par value of $100 per share out of the surplus or net profits of the corporation before any dividends could be paid on common, whenever the directors so declared a dividend. The dividends were cumulative as to the first 5% per annum whether earned or not, and cumulative as to the next 2% if earned. Common was not entitled to any dividends until preferred's current and accumulated dividends had been paid.

(c) Preferred, in the event of dissolution, winding up or liquidation was entitled to receive its par value plus an amount equal to all accumulated and unpaid dividends at the rate of 7% per annum to the date of distribution, before any distribution to common, though it was not entitled to share in any assets left after the payment of such amounts.

Common was entitled to receive such dividends as the directors should declare out of the surplus or net profits of the corporation, after all preferred dividend requirements had been met and accumulated dividends paid.

From 1926 to 1931, inclusive, dividends in ever diminishing amounts were paid on preferred; since 1931, no preferred dividend whatever was paid. As a result, accrued and unpaid dividends on preferred up to June 30, 1943, amounted to $69,875 per share, or a total of $7,295,788.50.

Meanwhile, war conditions had caused a sudden and tremendous increase in the earnings of defendant, as shown by the following table:

Year	*Profit*	*Loss*
1938	......	$ 7,544.
1939	$ 26,518.	......
1940	......	28,023.
1941	121,356.	......
1943 to June 30	569,555.	......

Between the years 1925 and 1943, the defendant had reduced its bonded indebtedness from $10,969,000 to $2,915,500. A modernization program was started in 1938 and continued until the war forced its suspension. This involved the replacement of much of the com-

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and/or the preceding fiscal year; provided, however, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired."

pany's equipment. The corporation's capital was seriously impaired, and though the balance sheet as of June 30, 1943, showed a surplus of $1,155,151.18, a deficit in fact existed.

For several years there had been agitation by the preferred stockholders, including the plaintiffs, for the payment of dividends currently to preferred stockholders. Various plans to accomplish this end were proposed and studied by the management. The directors were advised by counsel that under the circumstances, with the capital of the company impaired, an amendment to the certificate of incorporation was a prerequisite to the payment of dividends to preferred if the directors were to escape personal liability for such an act.

Finally, on September 1, 1943, the Board of Directors endorsed and proposed to the stockholders a plan which created a new class of noncumulative prior preferred stock. Holders of the new shares were to receive a dividend of $2.50 per share in 1943. Each year thereafter they were to receive $3.50 per share prior to the payment of any dividend on old preferred. Up to 50% of the net earnings of the corporation were to be applied to the payment of dividends on new preferred to the extent of $2.50 per share. Dividends on old preferred became noncumulative after January 1, 1943. All classes of stock were given one vote for each share at all meetings of stockholders. Holders of old preferred had the choice of retaining the old preferred or exchanging one share of old preferred for two of the new with the proviso that if the latter were accepted, then all claims for unpaid accumulated dividends to December 31, 1943 were to be waived. Before any dividends were payable on common, the new preferred was to receive $3.50 a share, and current dividends of $7 a year with all unpaid accrued dividends through December 31, 1943, were to be paid on the old preferred stock. On liquidation or redemption, old preferred became entitled to its par value of $100 a share plus all unpaid accumulated dividends. In such event two shares of new preferred would be the equivalent of one of the old.

The plaintiffs own 3200 shares of preferred stock, all of which were voted against the proposed plan. At a stockholders' meeting held on October 11, 1943, the plan was overwhelmingly approved as shown by the following table of votes cast:

For the resolution:	
Preferred Stock	67,110 shares
Common Stock	45,132 shares
Total	112,242 shares
Against the resolution:	
Preferred Stock	3,710 shares
Common Stock	2,000 shares
Total	5,710 shares

Before the adoption of the plan plaintiffs notified defendant of their opposition, and on October 8, 1943, three days prior to the aforementioned meeting, they filed a bill of complaint in the District Court seeking to enjoin its consummation. The plan entailed amending the certificate of incorporation of the defendant, and defendant agreed

orally to withhold action on such amendment until the decision of the District Court. On January 7, 1944, that court entered a final decree dismissing the bill of complaint. Defendants filed a notice of appeal on January 11, 1944, and on January 27 of the same year asked for an injunction pending appeal. As stated, the application for an injunction was granted by this court conditioned upon the filing of a bond in the sum of $20,000 by the plaintiffs for any damages and costs which might result to defendant if plaintiffs did not prosecute their appeal to effect. The plaintiffs did not post such bond, and on February 24, 1944, the corporation filed the certificate of amendments according to the laws of Delaware. A subsequent meeting of stockholders on March 21, 1944, approved the amendments and requested that dividends be paid as provided. Certain dividends have already been paid and others will be as they fall due.

The method of presenting the plan to the stockholders is assailed by the plaintiffs in connection with their contention of unfairness. As a result of counsel for the company advising the directors that the certificate of incorporation had to be amended in order to pay dividends currently on the preferred stock, the plan was formulated and sent out to the stockholders together with a letter from the president which read in part as follows:

"Broadly speaking, the meeting is to be held in order to give the stockholders of the corporation an opportunity to consider and vote upon amendments to Article Fourth and Article Ninth of the Certificate of Incorporation of The Denver Tramway Corporation in order to effectuate the Plan of Recapitalization unanimously adopted by the Board of Directors at the meeting held on the tenth day of August, 1943.

"The Board of Directors for many months has given very careful consideration to the problem of dealing with dividend accumulations on the Preferred Stock of your Corporation and to methods of enabling the Corporation to declare and pay dividends to the present holders of Preferred Stock from annual net profits. The solution of these problems has required the consideration of many other important related questions, such as taxes, accrued depreciation, and the modernization of the properties of the Corporation, which has been delayed by war conditions. The proposal fully set forth in the Plan of Recapitalization (Exhibit A) and accompanying amendments has the complete approval of the Board of Directors, has been devised after careful study, and is unanimously recommended to the stockholders for adoption as equitable and advisable and in the best interests of the Corporation and its stockholders." * * *

In the forty-eighth, forty-ninth and fifty-first findings of fact, the court also found: that the officers and directors of the defendant fully and fairly presented to the stockholders the legal and practical effect and purposes of the said plan and amendments; that they, and the majority stockholders, acted as the result of good faith with regard to the rights of others in the preparation, submission and adoption of the plan and amendments; and that the amendments were proposed in good faith without misrepresentation or fraud, either actual or con-

structive, and more freely adopted after full disclosure. A careful examination of the record shows that these findings are borne out by substantial evidence. Certainly we cannot hold that these findings are clearly erroneous. Federal Rules of Civil Procedure, Rule 52(a).

Under the Delaware law in order for the plan involved here to be held unfair it must amount to at least constructive fraud. It can be safely stated that all of the Delaware cases, even remotely touching the present question, have been ably discussed at length by counsel on both sides in the unusual number of briefs which have been filed. While there are no Delaware decisions dealing with the exact problem, this question of fairness has arisen in various merger cases under the Delaware Corporation Act. The latest opinion on the subject is Porges v. Vadsco Sales Corporation, Del.Ch.1943, 32 A.2d 148, at page 151, where Vice Chancellor Pearson said: "Complainant's case is simply that the allocation between the old preferred and common stockholders is so unfair that it amounts to fraud. When fraud of this nature is charged, the unfairness must be of such character and must be so clearly demonstrated as to impel the conclusion that it emanates from acts of bad faith, or a reckless indifference to the rights of others interested, rather than from an honest error of judgment." * * *

In addition to the lower court's findings of fact above detailed which directly relate to the fairness of the plan, the trial judge applying the test of Delaware decisional law to the issue here said in his opinion: "But my views are ineffectual in the light of my conclusion that the Delaware law controls. As there can be no possible finding of fact from the evidence adduced here to which the Delaware symbols of 'constructive fraud' or 'bad faith' or 'gross unfairness' may attach, the legal formula established by Delaware compels the result that plaintiffs' charge of unfairness can not be sustained."

Scrutiny of the testimony and exhibits reveals that the facts justify the findings of the trial court in this respect. In line with the thought expressed by Judge Leahy in his opinion below, it may well be that the vexing problem of the elimination of accrued dividends on preferred shares in such a situation as this litigation presents is a matter for Delaware legislative action, but as the corporation law of that state, both statutory and decisional, now stands, it calls for affirmance of the judgment of the District Court.

Affirmed.

NOTE

Corporate Cancellation of Accrued Preferred Dividends

The desire to eliminate accrued preferred dividends arises commonly when a period of business prosperity follows one of low earnings. As the corporate income and profits increase, holders of common stock find that the necessity of paying off the accruals built up for the preferred holders during the lean years prevents any immediate dividends on the common stock. This may discourage the common stockholders, or perhaps discourage new common investment, prevent necessary refinancing and interfere with profitable operation of a corporation financially stable but unable to progress due to its commitments to its holders of cumulative preferred stock. (55 Harv.L.Rev. 780, 783; 29 Va.L.R. 1, 12 et seq.) As a

result, and with a plea of corporate necessity, modern corporations have contrived means for cancelling such accruals, thus undoubtedly benefiting the common holders, often bettering the corporation, but all at the expense of the preferred holder, who loses his arrearages in exchange for what are often dubious advantages in the reorganized corporation. It is apparent that in each case there should be a balance reached between corporate necessity and the rights of the individual dissenting preferred holders, in order that the corporation be allowed sufficient flexibility yet the stockholder be not deprived of his just and equitable earnings.

Traditionally the stockholders' argument has been that any reduction or denial of preferred arrearages is invalid under the Federal (and usually State) Constitution. Accruals have been held vested interests (Yoakam v. Providence Biltmore Hotel Co., 34 F.2d 533, D.C.R.I. 1929: optional amendment plan), and preferred rights held inviolable under the due process and contract clauses (Roberts v. Roberts-Wicks Co., 184 N.Y. 257, 77 N.E. 13, 1906: capital reduction). Although there were some early cases in which the rights of preferred holders were allowed to be altered on the basis of statutory permission (Hinckley v. Schwarzchild, 107 App. Div. 470, 95 N.Y.S. 357, 1905: capital increase) or corporate necessity in the judgment of the directors (Windhurst v. Central Leather Co., 101 N.J.Eq. 543, 138 A. 772, 1927; Windhurst v. Central Leather Co., 105 N.J.Eq. 621, 149 A. 36, 1930; affirmed 107 N.J.Eq. 528, 153 A. 402, 1931: merger), the general rule of inviolability of preferred accrued dividends was firmly enough established that the decisions in the Keller (Keller v. Wilson, 190 A. 115, Del.1936) and Johnson (Consolidated Film Industries v. Johnson, 22 Del.Ch. 407, 197 A. 489, Del.1937) cases, holding that amendment of corporate charters pursuant to statute could not be interpreted as destroying dividends accrued prior to such amendment, were clearly anticipated.

At least three methods have been used in the attempt to eliminate preferred accruals (89 U. of Pa. L.R. 789, 794, 800, 803). A charter amendment attempts to create new classes of stock exchangeable for outstanding shares, usually in such manner that the preferred holder receives more new shares, or proportionately greater voting control than before; in exchange he gives up his old stock and arrearages. Charter amendment usually requires the vote of two thirds or more of all classes of stock; such concessions as are made to the preferred holders will usually elicit sufficient support to carry the proposal, thereupon providing the corporation with the argument of majority consent as against the dissenters' claims of unjust or inequitable treatment.

A second common method of recapitalization is by "merger" with another corporation, with a resulting exchange of shares of the two former corporations for stock in the new body, in the course of which arrearages are eliminated. Merger is not dissolution of either corporation, and special preferred rights on dissolution do not arise therefrom (Adams v. U. S. Distributing Corp., 184 Va. 134, 34 S.E.2d 244, 1945); nor does the fact that the merger is with a wholly owned subsidiary, or even with one created solely for the purpose of the merger, affect the plan adversely (Hottenstein v. York Ice Machinery Corp., 136 F.2d 944, 953, C.C.A. Del.1943). When the merger technique is employed, dissenters are allowed the statutory right of appraisal as an alternative (or in most cases, as the sole alternative.) (Adams v. U. S. Distributing Corp. 184 Va. 134, 34 S.E.2d 244, 1945; Hubbard v. Jones & Laughlin Steel Corp., 42 F.Supp. 432, D.C.Pa.1941; 87 A.L.R. 603, 162 A.L.R. 1250.)

Creation of prior preference stock by charter amendment is a means of "optional" recapitalization, whereby the preferred holder need not exchange his present stock and accruals for the new issues, but the old stock will be subjected to a prior preference and consequent loss of its first call on corporate profits. Here the alternative of appraisal may be allowed, or the option may be considered sufficient alternative in itself to secure the shareholder. (Johnson v. Lamprecht, 133 Ohio St. 567, 15 N.E.2d 127, 1938; cf. Patterson v. Durham, 214 N.C. 806, 200 S.E. 906, 1939.)

In the Keller and Johnson cases, the charter amendment method of eliminating accruals was prevented, both due to failure of the statute specifically to provide for destruction of rights "in the nature of a debt" and, as a necessary corrollary, on the basis of the vestedness of the arrearages. (Wheatley v. Root, 147 Ohio St. 127, 69 N.E.2d 187, Ohio 1946; cf. 55 H.L.R. 71, 88). The Havender case (Havender v. Federal United Corp., 24 Del.Ch. 318, 11 A.2d 331, 1940) came as a surprise; there the plan was merger with a wholly owned subsidiary, and the court upheld the merger with its resulting cancellation of accruals, distinguishing the Keller and Johnson cases on the facts and basic statutes. The holding, while asserting the defeasibility of accrued dividends, did not claim to overrule the principle of vestedness asserted in those cases; citation of the alternative of appraisal as preventing deprivation of property without due process of law indicated that the court had not yet reached the point of denying the preferred holders' property right in so many words. Recognition of the fact that the vestedness theory was abandoned and that the Havender case repudiated the doctrine, (although not the result, since different statutes were involved) was given in another merger case (Hottenstein v. York Ice Machinery Corp., 136 F.2d 944, C.C.A.Del.1943). And in the Shanik and Barrett cases, the charter amendment providing optional exchange for prior preference stock was also allowed in Delaware (Shanik v. White Sewing Machine Corp., 19 A.2d 831, Del.1941; Barrett v. Denver Tramway Corp., 146 F.2d 701, C.C.A.Del.1944).

In New York, Davison v. Parke Austin and Lipscome Inc. (285 N.Y. 500, 35 N.E.2d 618, 1941) followed the Keller result in denying the corporation's right to eliminate accrued dividends by charter amendment, but the basis of the holding was not the indefeasible vestedness of the arrearages but solely the absence of explicit statutory permission for a corporation to alter preferred rights. 1943 amendments to section 36 of the Stock Corporation Law added these powers, and the McNulty case (McNulty v. Sloan, 184 Misc. 835, 54 N.Y.S.2d 253, 1945) held the statute constitutional where used to destroy accruals by charter amendment. Since Zobel v. American Locomotive Co. (182 Misc. 323, 44 N.Y.S.2d 33, 1943) had allowed the elimination of arrearages by consolidation and merger with a wholly owned subsidiary, a variety of methods are open in New York.

With increasing acceptance of the power of the corporation to cancel arrearages, there has appeared no correlative development of judicial techniques for assuring dissenting shareholders of equitable treatment either in the recapitalization plan or in alternatives to it. Appraisal is often the sole statutory alternative, in the absence of fraud or illegality (Barnett v. Philadelphia Meat Market Co., 218 Pa. 649, 67 A. 912, 1907), although the inadequacy of that method to compensate for stock and arrearages will probably result in loss to the stockholder (Langfelder v. Universal Laboratories Inc., 68 F.Supp. 209, D.C.Del.1946; 45 H.L.R. 233; 57 H.L.R. 895). Where the plan is optional, the fact that any exchange is "voluntary" leads the court to consider it equitable (Shanik case, supra; cf. Patterson v. Durham, supra). But far more important for the protection of preferred holders than adequate alternatives is an equitable review of the plan itself to assure that it will work no injustice on dissenters. This the courts have attempted by the requirement that a recapitalization be "fair and equitable". In the handling of similar problems by the SEC, wherein necessity of reorganization and fairness to all classes is considered (Federal Water Service Corp., 8 SEC 893; Public Utilities Holding Co. Act, sec. 7(e), 11(e); Bankruptcy Act ch. X), "fair and equitable" have come to mean an absence of actual or constructive fraud on the part of the proponents of the plan. But, under Delaware decisions (Porges v. Vadsco Sales Corp., 32 A.2d 148, Del.1943), "unfairness" must amount for bad faith and reckless indifference to the rights of the preferred holders before the courts will interfere with the plan. And since the courts hold that the reasons for or business necessity behind the recapitalization are not matters for judicial deter-

mination (MacCrone v. American Capital Corp., 51 F.Supp. 462, D.C.Del.1943), and that the judgment of the directors as to the plan must be presumed to be in good faith and to the best interests of the corporation (Barrett v. Denver Tramway Corp., supra), it will be a rare and blatantly fraudulent case in which the court will interfere.

The ease with which corporations today can eliminate accruals without strict regard for the value given to the preferred owner has been criticized, not so much for the great increase in power thereby afforded the corporation as for failure of the courts to establish equitable standards for the protection of the holders of stock with arrearages (29 Va.L.R. 1, 2, 24). The two principal suggestions for court review of capitalization plans for fairness to dissenters are: first, that the corporation be required to show actual and present necessity for reorganization eliminating accruals, (such necessity to be demonstrated by an actual attempt to refinance and impossibility due to arrearages, rather than merely by assertion that refinancing is difficult when there are arrearages); second, by the requirement that the plan provide a substantial equivalent for the accrual which it sacrifices, (substantiality to be determined in terms of the value of stock, priorities, preferences and control given in exchange for the old preferred, 29 Va.L.R. 1; 55 H.L.R. 780). For, unless the quid pro quo provides the preferred holder with a greater money value of stock than before, or greater dividend rate, or substantially greater privilege in the corporation, he has received nothing for the elimination of his accrued dividends and the corporation has achieved its flexibility in refinancing at his expense. (57 H.L.R. 894, 899.)

On this topic, generally, see, Frey, Private Corporations, Significant Developments in the Law During the War Years (Practising Law Institute, 1946) 59, 72; Meck, Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine (1941) 55 Harv.L.Rev. 71; Notes (1942) 55 Harv.L.Rev. 1196, (1944) 57 Harv.L.Rev. 894.

(b) "Blank Stock"

AUTHORIZATION OF "BLANK" PREFERRED STOCK

It has been noted that under § 5, par. 4 of the Delaware (and under § 11 of the New York) corporation act, certificates of incorporation may authorize the issue of a stated number of shares of preferred stock, which may be divided into series (that is, an issue of preferred stock, Series A; later, another issue of such stock, Series B, and so forth); and granting to the Board of Directors the right by resolution at time of issue, to determine the dividend rate, preferences and privileges of each such series. A charter may, but need not, limit the power of directors in fixing such preferences.

This is perhaps, high-water mark in giving to managements unrestricted power over the position of stockholders. For instance, a corporation may be empowered in its charter to issue preferred stock, under the "blank stock" provision. It may then issue a respectable Series A preferred stock, carrying a cumulative dividend of $5.00 per year, entitled to receive in preference to the common stock $100 and no more in case of liquidation or dissolution; and so forth. This may be sold as an investment issue. Later, the directors may issue a Series B preferred stock carrying a cumulative dividend of, say, $50 per share annually, a preference on liquidation of, say, $1000, and so forth. Particularly if the charter likewise includes a waiver of pre-

emptive rights such a series could be framed to absorb practically all of the future earnings and possibilities of the corporation, and it could be issued in such fashion that the existing stockholders would have no chance to vote upon the proposal, or to subscribe to the new stock or otherwise to protect themselves; in a word, would have no intra-corporate remedy.

Were the issue of such a series attacked in the courts, the attorneys for the corporation undoubtedly would insist that there was a presumption (though rebuttable) that the directors had acted in the business interest of the corporation, and that courts should not interfere with the ideas of the directors as to the development and financing of the business. In Delaware, at least, this presumption apparently would have some force, despite the fact that the presumption originally arose from the fact that directors, elected by stockholders all of whom were interested in the corporation, might be assumed to act in the interest of their stockholders. Economically, of course, this is no longer the case. Students may wish to consider the probabilities of future legal development in connection with this and similar grants of virtually absolute power to directors. Such powers can, of course, be used legitimately. In theory, the "blank stock" provision was designed to permit directors to issue preferred stock at varying rates of dividend, depending on the current rates for money. Thus, when preferred stock normally commands a dividend rate of 6%, a preferred share designed to sell at $100 would have to have a cumulative dividend of $6.00 per year to be saleable in the investment market. Later, when dividend rates decline, another issue might be floated at a 4% rate. The legitimate use of the "blank stock" provision would be adapting preferred stock issues to the money market, so that advantage could be taken of favorable rates without completely revamping the charter each time. But the freedom thus given offers likewise wide possibility for illegitimate use.

If, as the United States Supreme Court observed in Pepper v. Litton (308 U.S. 295, 60 S.Ct. 238), corporate powers are "powers in trust", there is plain equitable control which a shareholder might invoke against abuse of this singularly wide power. But if the rather slashing observations of Mr. Justice Holmes in Barclay v. Wabash Railway Co. (280 U.S. 197, 50 S.Ct. 106) are accepted, the investor who buys into this sort of corporation is merely an imprudent fool who gets what he deserves.

The "blank stock" clauses in New York and Delaware are, at the moment (1948), frontier posts in the long struggle between managements to secure unquestioned power, and prohibitions to subject that power to equitable control where it is unfairly used. There being no decided cases, the issue is still in doubt in this area.

(c) By Merger

FEDERAL UNITED CORPORATION v. HAVENDER.

HAVENDER et al. v. FEDERAL UNITED CORPORATION.

Supreme Court of Delaware, 1940. 24 Del.Ch. 318, 11 A.2d 331.

Bill in equity by Joseph Havender, Sr., and another against Federal United Corporation to declare void the merger of the defendant with its wholly-owned subsidiary, Corporation Bond & Share Company, in so far as the merger and recapitalizing the defendant corporation undertook to convert complainant's preferred shares into other securities without paying in money dividends accrued thereon. From a decree for the complainants, 6 A.2d 618, both parties appeal.

Reversed, with directions. * * *

LAYTON, CHIEF JUSTICE. The first question to be decided is whether a merger of a parent corporation with a corporation wholly owned by it is within the purview of Section 59 of the General Corporation Law. The late Chancellor, indirectly, gave a negative answer. He made no reference to the amendment of April 13, 1937, designated as Section 59A; and we prefer to think that the amendment was not called to his attention, for in such case, no doubt, there would have been some modification of expression. The present Chancellor was specific. In his opinion a merger of a parent corporation with its wholly-owned subsidiary was not within the contemplation of Section 59. This was apparent, as he said, from the provision that the merger agreement shall state the "manner of converting the shares of each of the constituent corporations into shares of the consolidated corporation"; and he referred to the amendment, designated as Section 59A, as indicating that the Legislature had found it necessary to amend the General Law by expressly authorizing mergers between parent companies and their wholly-owned subsidiaries.

We find ourselves unable to agree with this view. By Section 59, any two or more corporations organized under the General Corporation Law, or existing under the laws of this state, for the purpose of carrying on any business, may merge. The language of the authority is plain, understandable and general. The power is not qualified or restricted by limitation or exception. Limitations on power are usually to be found in the language of the grant, or in a reservation or exception attached to the grant. The language singled out by the learned Chancellor as indicating a limitation on the general authority conferred is not concerned with extent of the power granted. It relates to the details of merger agreements; and is general directory language applicable, mutatis mutandis, to all circumstances of mergers and consolidations. An exception to the all-embracing authority conferred by the section is not, we think, to be found in the language seized upon. The general rule of statutory construction repeatedly affirmed by the courts of this state generally, and, in particular, by this court, is that where the language of a statute is plain and conveys

a clear and definite meaning, the courts will give to the statute the exact meaning conveyed by the language, adding nothing thereto, and taking nothing therefrom. Van Winkle v. State, 4 Boyce 578, 27 Del. 578, 91 A. 385, Ann.Cas.1916D, 104. And, specifically, where the Legislature had made no exception to the positive terms of a statute, the presumption is that it intended to make none, and it is not the province of the court to do so. Lewis v. Pawnee Bill's Wild West Co., 6 Pennewill 316, 66 A. 471, 16 Ann.Cas. 903.

It is for the Legislature not for the court, to declare the public policy of the state; and it is not, therefore, the function of the court to graft an exception on the plain and positive terms of the statute. * * *

We are of opinion, therefore, that a merger of a parent corporation with a subsidiary wholly owned by it is within the purview of Section 59 of the Corporation Law.

Next to be considered is whether, under the merger and consolidation provisions of the General Corporation Law, and apart from those provisions with respect to a valuation of stock either by agreement or by appraisal, dividends accumulated on the cumulative preference stock of one or more of the constituent companies may be disposed of other than by paying to the dissatisfied shareholder the amount of them in money.

Neither of the learned Chancellors below thought it necessary to consider the question. In their view, the corporate proceeding complained of, while styled a merger, was no more than an unauthorized attempt at a recapitalization of the defendant corporation, ineffective, as against objection, to extinguish accumulated dividends on preference stock within the rule announced by this court in Keller v. Wilson & Co., Inc., Del.Sup., 190 A. 115.

The complainants, founding their position on the Keller case, insist that the merger sections of the Corporation Law not only do not authorize, and could not validly authorize, the abrogation of dividends accumulated on preference stock, but, on the contrary, expressly preserve the right to such dividends. The contention is that in the Keller case this court held that the right of a holder of cumulative preferred stock to eventual payment of dividends in arrear on his stock was a fixed contractual right, a right in the nature of a debt, in that sense vested, and not to be taken away by a voluntary recapitalization without the consent of the holder of the stock. In the cited case, a recapitalization of a corporation under Section 26 of the General Corporation Law, Code 1935, § 2058, was involved. At the time of the formation of the corporation and the issuance of the stock, the right of the holder of cumulative preferred stock to dividends accrued thereon through time was protected against destruction by charter amendment under Section 26. Relying on an amendment to the section subsequently enacted, the corporation attempted to cancel the dividends accrued on its preference stock. It was held that there were limitations on the general reserve power of the state. The rationale of the decision, stated and reiterated, was that when the nature of the right of the holder of cumulative preferred stock to unpaid dividends ac-

crued thereon through time was examined in a case where the right was accorded protection when the corporation was formed and the stock was issued, it was such a right that could not be destroyed by corporate action taken under an authority subsequently conferred. In such circumstances, the right was considered to be of the dignity of a fixed contractual right in the nature of a debt. The decision has no application beyond its philosophy. It has no bearing on the question in dispute. The substantial elements of the merger and consolidation provisions of the General Corporation Law as they now appear have existed from the time of the inception of the law. It is elementary that these provisions are written into every corporate charter. The shareholder has notice that the corporation whose shares he has acquired may be merged with another corporation if the required majority of the shareholders agree. He is informed that the merger agreement may prescribe the terms and conditions of the merger, the mode of carrying it into effect, and the manner of converting the shares of the constituent corporations into the shares of the resulting corporation. A well understood meaning of the word "convert", is to alter in form, substance or quality. Substantial rights of shareholders, as is well known, may include rights in respect of voting, options, preferences and dividends. The average intelligent mind must be held to know that dividends may accumulate on preferred stock, and that in the event of a merger of the corporation issuing the stock with another corporation, the various rights of shareholders, including the right to dividends on preference stock accrued but unpaid, may, and perhaps must, be the subject of reconcilement and adjustment; for, in many cases, it would be impracticable to effect a merger if the rights attached to the shares could not be dealt with. The state has an interest in the corporate structures erected under its authority. Having provided for the merger of corporations, they are not regarded with disfavor. On the contrary, mergers are encouraged to the extent that they tend to conserve and promote corporate interests. The catholic quality of the language of the merger provisions of the law negatives a narrow or technical construction if the purpose for which they were enacted is to be accomplished. MacFarlane et al. v. North American Cement Corporation, 16 Del.Ch. 172, 157 A. 396. Moreover, it is recognized that there may be shareholders who will be dissatisfied with the effect of the terms of the merger proposal upon the rights attached to their shares. While their right to dissent is admitted, the public policy of the state declared by the statute, somewhat analogous to the right of eminent domain, does not permit a dissenting shareholder, as against an affirmative vote of two thirds, to veto a merger agreement if its terms are fair and equitable in the circumstances of the case. Within the time and in the manner provided by the statute, the dissatisfied stockholder, if he so desires, may demand and receive the money value of his shares as that value has been agreed upon or has been determined by an impartial appraisement. Consequently, in a case where a merger of corporations is permitted by the law and is accomplished in accordance with the law, the holder of cumulative preference stock as to which dividends

have accumulated may not insist that his right to the dividends is a fixed contractual right in the nature of a debt, in that sense vested and, therefore, secure against attack. Looking to the law which is a part of the corporate charter, and, therefore, a part of the shareholder's contract, he has not been deceived nor lulled into the belief that the right to such dividends is firm and stable. On the contrary, his contract has informed him that the right is defeasible; and with that knowledge the stock was acquired. In such situation the shareholder is not confronted, as was the complainant in the Keller case, with a proposed alteration of rights attached to preference stock not within the contemplation of the law as it stood when the corporation was formed and the stock issued (except as an alteration of rights may be said to be imagined under the general reserve power of the state) and with no alternative right to demand and receive the value of his stock in money.

The broad contention advanced by the appellees, that the merger provisions of the General Corporation Law do not authorize the extinguishment of dividends accumulated on preference stock, even if the terms of the merger proposal are fair and equitable, must be denied, unless the effect of the qualifying clause at the end of Section 60 is such as to compel the recognition of such unpaid dividends as a debt or liability of the corporation enforceable against the resulting corporation.

It is to be supposed that the Legislature intended to give to the words and terms employed by it their usual and ordinary meaning and significance. A holder of preference shares as to which dividends have accumulated through time is not a creditor of the corporation in the ordinary and usual meaning of the word; nor is he the holder of a lien as that word is usually understood. In proximate contextual relation to the words, "creditors" and "liens", are the words, "debts", "liabilities" and "duties". The connotation of these words, having in mind the significant fact that there is nothing in the section that purports to deal with the rights of shareholders, leads to the conclusion that the words and terms were not intended to refer or to be applicable to the results of the contractual relation arising out of stock ownership either as between the shareholders inter sese, or as between the shareholder and the corporation. The words and terms are readily to be understood as referable to persons external to the corporation, and to debts, liabilities and duties due from the corporation to them, and not to those internal liabilities and duties of the corporation to the shareholder which spring from that relationship. If the legislative intendment had been otherwise, the necessity for positive and unequivocal language is plainly indicated; and it would not have been difficult to make clear the meaning and purpose of the qualifying clause. Considering as a whole the merger and consolidation sections of the General Law, we are not willing to ascribe to the words and terms of the qualifying clause of the section a significance that would make them comprehensive of such internal liabilities of the corporation as may be supposed to proceed from the recognition of unpaid dividends accumulated on preferred stock as in the nature of a debt

due from the corporation to the shareholder. See 1 Machen, Corporations, § 538. * * *

It will be noticed, of course, that the merger plan, in no sense, provided for the "literal enforcement" of the rights of the preferred shareholders, for they were to receive only $5 in money as against $43 accrued on the preferred stock, and the total of the values to be received by them was only $78 as against a face value of $143. Notwithstanding, the plan of conversion was held to be fair and equitable. The observations of the Vice-Chancellor are utterly irreconcilable with the theory that, in no case, can dividends accumulated on preferred stock be extinguished except by their payment in money against the objection of a dissenting shareholder; and, as his conclusions were approved by the Appellate Court, we are unable to view the Windhurst case in any light other than as permitting, in the case of merger of corporations, dividends accrued on preference stock to be disposed of other than by money payment, if the plan of merger is fair and equitable in the circumstances of the case, not operating to enrich one class of shareholders at the expense of holders of preferred stock.

There is no invasion of legal or equitable right, nor is there moral wrong, in disposing of dividends on preference stock accumulated through time other than by their payment in money, if the right to such dividends has not the status of a fixed contractual right under the law as it stood when the corporation was formed and the stock was issued, and if the terms of disposal are fair and equitable in the circumstances of the case; and especially is this true where provision is made for payment of the value of the shares to the dissatisfied shareholder. To say that the right to such dividends may not be destroyed by charter amendment under Section 26 of the General Law which, when the corporation was formed and the stock issued, did not authorize the destruction of the right, and with no alternative right in the shareholder to demand payment in money of the value of his stock, is not to say that the right may not be compounded under the merger provisions of the law which warn the shareholder that his right is defeasible, and which, if he is dissatisfied, entitle him to demand and receive the money value of his shares. There is a clear distinction between the situations recognized by the General Law and the modes of procedure applicable to each of them; and we think that the strictness of view of the merger provisions of the law entertained by the learned Chancellors below was, perhaps, induced by overlooking the distinction, so that it was assumed that to attempt to accomplish by merger that which could not be done by mere charter amendment, was a perversion of the statute in an effort to escape the reach of the decision in the Keller case.

It is not suggested that the terms of the plan of merger were unfair or inequitable. We conclude, therefore, that the accumulations of dividends on the preference stock of the defendant corporation were lawfully compounded. The complainants were put to their election, either to demand payment in money of the value of their preferred shares as agreed upon, or as ascertained by an appraisement, or to accept the exchange of securities offered by the merger plan. No

effort was made to agree upon a valuation of the shares, and no appraisement was sought. Manifestly, under the provisions of the statute, a valuation cannot be demanded now. The complainants must accept the terms of the merger agreement. * * *

The decree of the court below is reversed, with the direction to enter a decree dismissing the bill of complaint, with costs on the complainants.

HOTTENSTEIN et al. (Moore, Intervenor) v. YORK ICE MACHINERY CORPORATION.

Circuit Court of Appeals of the United States, Third Circuit, 1943. 136 F.2d 944.

Action by Charles A. Hottenstein and another against York Ice Machinery Corporation to prevent the merger of the defendant with the York Corporation, wherein R. Thomas Moore intervened. From a judgment, 45 F.Supp. 436, dismissing the case on the merits, the intervenor appeals.

Affirmed.

BIGGS, CIRCUIT JUDGE. The intervening plaintiff, the appellant in the case at bar, is the owner of 50 shares of 7% cumulative preferred stock issued by the defendant York Ice Machinery Corporation, a Delaware corporation. The defendant was incorporated on March 22, 1927. On January 25, 1941 the outstanding capital stock of the defendant consisted of 56,371 shares of cumulative preferred stock [63] and 161,481 shares of common stock. On that date the unpaid accumulated dividends on each share of the preferred stock amounted to $88.25. The defendant also had bonds due October 1, 1947, in the principal amount of $5,808,500 and 10 year 6% sinking fund gold debentures in the principal amount of $612,000 which previously had borne a due date of December 1, 1937, but which had been extended to December 1, 1943. The defendant also owed certain unsecured 3% notes to the amount of $118,500 due December 1, 1944. Its current liabilities, on the date specified, including sums due to trade creditors and taxes, payrolls, and interest on long term indebtedness calculated on an accrual basis, amounted to approximately $1,150,000.

Its assets as of September 30, 1940, were cash in excess of $1,000,000, notes and accounts receivable of more than $3,500,000 and inventories worth $3,800,000. It possessed miscellaneous assets including customers' notes, accounts receivable, stocks, bonds, mortgages and the capital stocks of affiliated companies worth more than $900,000. The defendant also owned a plant carried on its books at a value in excess of $7,000,000.

On January 25, 1941, the asset position of the defendant was good. It was solvent and its current assets greatly exceeded its current obligations, though refinancing of its funded debt obviously was required.

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[63] Each share preferred stock is entitled to $100 and all unpaid accumulated dividends on the liquidation or dissolution of the defendant. Each share of preferred stock may be redeemed by the defendant at the rate of $107.50 plus unpaid accumulated dividends.

Specifically it appears from a balance sheet of the defendant as of September 30, 1940, that an equity of about $4,300,000 was available for the preferred stock. The unpaid accumulated dividends on the preferred stock then amounted to approximately $4,600,000.[64] An examination of the income account of the defendant year by year for the five years ending September 30, 1940, shows its operations resulted in net income in 1940 of $483,121, in a loss in 1939 of $185,076, in a loss in 1938 of $118,753, in net income in 1937 of $957,649 and in net income in 1936 of $165,586. The financial statement of the defendant also shows a net income of $1,202,000, for 1941. The earned surplus for this year was in excess of $800,000 contrasting with an earned surplus of $403,000 for the year 1940.

On January 25, 1941 the board of directors of the defendant sent a letter to each of its stockholders and presented for their consideration "a Plan for the Recapitalization of the Company". * * *

The plan of recapitalization proposed by way of merger was that each share of the preferred stock of the defendant with accumulated dividends should be converted into fifteen shares of common stock of York Corporation as the "surviving" corporation, and that each share of the common stock of the defendant should be converted into one share of common stock of York Corporation. Upon consummation of the merger and the issuance of the new stock the holders of the preferred stock of the defendant will own 83.2% of all of the stock of York Corporation. The voting power of the present holders of the preferred stock of the defendant will be increased from 24.8% to 83.2%. It should be noted that the plan of recapitalization does not purport to deal with the funded indebtedness of the defendant in any way. The directors' letter to the stockholders of the defendant also states that the common stockholders will benefit by the elimination of the prior claims of $10,047,090, representing the par value of the preferred stock plus the cumulative dividends accrued thereon as of January 25, 1941, and the preferred stockholders of the defendant will be benefited by their equity in the future earnings of York Corporation. The letter then states that it should be observed that the company's sales for the three months ending December 31, 1940, were $5,107,373, as compared to $3,588,630 in the same period of 1939; that the existing debt structure of the defendant with the sinking fund requirements and restrictions of the payment of dividends is a severe burden on the defendant and its stockholders; that refinancing of the funded debt is impeded by the arrearage of dividends on the preferred stock, and, if the plan of recapitalization is adopted, that "* * * it will be possible to consider re-financing more advantageously and it may then be to the advantage of the Company to provide a part of the monies necessary, by the issuance of convertible bonds * * * [a result] * * * obviously impossible while the Preferred Stock is outstanding." * * * it was the intention of the

64 The last dividend upon the preferred stock was paid on January 2, 1931. Since the incorporation of the defendant the dividends paid on the preferred stock amounted to $4.50 a share. No dividend has ever been paid on the common stock.

defendant to reclassify its stock by way of merger with its wholly owned subsidiary, York Corporation.

York Corporation is also a Delaware corporation. It was incorporated at the direction of the defendant on or about January 5, 1939. Its charter provides that its capital stock shall consist of 250 shares of stock without par value. The defendant purchased twenty shares of the stock of York Corporation for $1,000, the stock, having a stated value of $50 a share. On October 11, 1940, the president and secretary of York Corporation issued to the defendant a certificate for 20 shares of stock. No other certificate has been issued. York Corporation has never carried on business. So far as appears from the record, it stood awaiting merger with the defendant. * * *

On the day of the adjourned meeting the merger was consummated, 40,527 shares of preferred and 121,326 shares of common stock being voted in favor of the resolution and merger, 1,499 shares of preferred stock and 240 shares of common stock being voted against the resolution and merger out of the total of 56,571 shares of preferred stock and 161,481 shares of common stock issued and outstanding.

Additional facts must be stated. Over 50% of the common stock of the defendant was owned by two directors and members of their family groups. The directors and their groups owned less than 25% of the preferred stock. The original complaint was filed in the court below on March 12, 1941. The appellant filed his intervening complaint on May 27, 1941. The latter complaint alleges that the appellant has brought his suit not only on his own behalf but also on behalf of all persons situated like unto himself. He prayed for a preliminary injunction to restrain the defendant from holding the adjourned stockholders meeting to vote upon the proposed merger, and, in the event the court declared that the accrued accumulated dividends on the preferred stock could not be affected by the merger, that the defendant be enjoined "* * * from paying dividends upon any of the capital stock without first providing for and liquidating the arrears of dividends which up to January 25, 1941, [had] accrued on the preferred stock of the intervening plaintiff * * *". An answer was filed and hearings were held.

No preliminary injunction was granted. The learned District Judge dismissed the cause upon the merits. See, D.C., 45 F.Supp. 436. The appeal at bar followed.

We think it clear from the facts of the case at bar that the defendant has evoked the provisions of Section 59 of the General Corporation Law of Delaware, Section 2091, Revised Code 1935, in order to avoid the effect of the decisions of the Supreme Court of Delaware in Keller v. Wilson & Co., Inc., 21 Del.Ch. 391, 190 A. 115, which reversed the decision of Chancellor Wolcott, 21 Del.Ch. 13, 180 A. 584, and in Consolidated Film Industries v. Johnson, 22 Del.Ch. 407, 197 A. 489, which affirmed the decision of that Chancellor, 22 Del.Ch. 262, 194 A. 844. The cases cited arose under Section 26 of the General Corporation Law of Delaware, Section 2058, Revised Code 1935. The decisions of the Supreme Court of Delaware in the Keller and Consolidated Film Industries cases are so well known to the bench and bar of this circuit

that there is no need to dwell on them at great length in this opinion. It is enough to say that following the decision of the Supreme Court in the cited cases the directors of a Delaware corporation and its stockholders knew that whether a class of cumulative preferred stock was created before or after the 1927 amendments to Section 26 of the General Corporation Law (35 Del.Laws, c. 85, Sec. 10), accrued accumulated dividends could not be adjusted by the provisions of Section 26. In short, it was clear that a preferred stockholder's right to accumulated unpaid dividends could not be divested by a reclassification under Section 26 of the General Corporation Law even when a majority of the stockholders of the class consented thereto over the objection of dissident stockholders. * * *

It follows, as Chancellor Wolcott pointed out, in his opinion in Johnson v. Consolidated Film Industries, supra, that it would make no difference if the corporation, whose preferred stock was to be divested of unpaid accumulated dividends, was incorporated before or after the 1927 amendment to Section 26 or if the issuance of the preferred stock was authorized before or after that amendment. The cancellation of accumulated dividends, accrued through the passage of time, had been held by the Supreme Court in the Keller case not to be an amendment to a Delaware charter. We think it is fair to state that the bar generally concluded that the right of a preferred stockholder to unpaid accumulated dividends could not be affected or adjusted without his consent. This conclusion was short-lived. * * * If it is fair to say that the decision of the Supreme Court of Delaware in the Keller case astonished the corporate world it is just to state that the decision of the Supreme Court in Havender astounded it, for shorn of rationalization the decision constitutes a repudiation of principles enunciated in the Keller case and in Consolidated Film Industries v. Johnson, supra. * * * The right of the preferred stockholder in the instant case is to receive payment of his unpaid dividends in preference and priority to the payment of any dividend on the common stock. Such a right should not be given the status of a vested property right in view of the power of self-amendment conferred on the defendant by the 1927 amendment to Section 26 which was in force when the defendant in the case at bar was incorporated and when the charter amendment authorizing the issue of preferred stock was lodged with the Secretary of State of Delaware. In view of the power of self-amendment conferred upon the defendant we think it is clear that the intervening complainant may not claim the protection of the Contract Clause. We think for the reasons stated hereinafter that he is not entitled to make the claim that he is being deprived of his right without due process of law within the purview of the Fourteenth Amendment. We are called upon simply to interpret the law of Delaware. Erie R. Co. v. Tompkins, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188, 114 A.L.R. 1487.

After reflection we find ourselves unable to reconcile the decision of the Supreme Court of Delaware in the Havender case with its pronouncements in the Keller case that cancellation of cumulative dividends accrued through the passage of time is not an amendment

of a charter and that the right of a holder of cumulative preferred stock to unpaid dividends is a vested right of property secured against destruction by the Federal and State Constitutions. While the approach of the Supreme Court in the Havender case was through Section 59, which, as was stated, had remained substantially unchanged in form since the adoption of the General Corporation Law in 1899, 21 Del.Laws c. 273, and the approach in the Keller case was through Section 26, we must conclude that Havender broke Keller's back. * * *

It follows, therefore, that it is the law of Delaware that a parent corporation may merge with a wholly owned inactive subsidiary, cancelling old preferred stock and the rights of the holders thereof to unpaid accumulated dividends, substituting in lieu thereof stocks of the surviving corporation.[65]

It should be noted that the question of fairness of the reclassification was not considered by the Supreme Court in the Havender case and the case was disposed of (the holding as to laches aside) on the ground of corporate power. It should be observed also that Chancellor Wolcott upheld Wilson & Company's proposed reclassification in the Keller case without considering the fairness of the plan and that the Supreme Court held the reorganization invalid on a ground which rendered fairness irrelevant. In the recent case of Porges v. Vadsco Sales Corporation, Del.Ch.1943, 32 A.2d 148, 150, the Vice-Chancellor of Delaware devotes a substantial portion of his opinion to a discussion of the question of fairness. In the Porges case a merger was proposed pursuant to the provisions of Sections 59 and 59A of the General Corporation Law between a parent and its wholly owned subsidiary. The Vice-Chancellor lays emphasis upon the provisions of Section 61 of the General Corporation Law, Section 2093, Revised Code, 1935, as amended, which provides that a stockholder objecting to a merger or consolidation may withdraw from the enterprise and obtain payment in money for the value of his stock. He quotes from the decision of Chancellor Wolcott in Cole v. National Cash Credit Association, 18 Del.Ch. 47, 56, 156 A. 183, 187, as follows: " 'As a general proposition dissenting stockholders are thus put to an election by the statute.' " In respect to the issue of fairness the Vice-Chancellor states, "However, there are exceptional circumstances under which a stockholder is not obliged to make an election to accept the merger or to demand the value of his stock in money, but may enlist the aid of a court of equity to restrain the consummation of the merger. In the Cole case, the Chancellor gave examples of such circumstances, and said, 'The exercise of the statutory right of merger is always subject to nullification for fraud.' "

An examination of the examples cited in the Cole case leads us to the conclusion that actual fraud will cause the Delaware courts to restrain a merger. Actual fraud amounts to misrepresentation, concealment or deception. The allocation of equities in the surviving corporation

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65 It should be noted that in the Havender case as in the case at bar a surplus was available for the payment of dividends on the preferred stock. In the Havender case there was no earned surplus as there is in the case at bar. An earned surplus is not necessary in order to pay dividends under the law of Delaware.

between the old preferred and common stockholders may be so unfair as to amount to constructive fraud in the eyes of the Delaware Courts. Vice-Chancellor Pearson states, "When fraud of this nature is charged, the unfairness must be of such character and must be so clearly demonstrated as to impel the conclusion that it emanates from acts of bad faith, or a reckless indifference to the rights of others interested, rather than from an honest error of judgment", citing the Cole case and MacFarlane v. N. A. Cement Corporation, 16 Del.Ch. 172, 157 A. 396.

In the case at bar can it be asserted justly that the reclassification which is actually worked by the merger is so unfair to the intervening complainant and those like situated that it amounts to constructive fraud? The balance sheet of the defendant corporation shows that as of September 30, 1940, the equity above the par value of the cumulative preferred stock amounted to $4,384,000, whereas as of that day the arrearage of dividends on the preferred stock amounted to $4,616,-000. This arrearage was accumulating at the rate of 7% per annum. Upon the other hand, the earnings of the defendant have increased substantially and by the merger the preferred stockholders gain control of the company. It should be noted also that when the plan of reclassification by merger became public the preferred stock nearly doubled in price on the market. The increased earnings should create an equity for the common stockholders of the defendant. Substantial funded indebtedness must be refinanced in the not distant future. As a practical matter we know that it is difficult to refinance corporate indebtedness when there are heavy arrearages of accumulated dividends outstanding. A corporation so situated reasonably may expect litigation and its concomitant miseries. Bankers are loath to float security issues under such circumstances. We are of the opinion that it is not unjust under all the circumstances of the case at bar to treat the equity of the common stockholders as being worth approximately 17% of the stock of the surviving corporation. It follows that the reclassification is fair.

We come, therefore, to the final question in the case at bar, which, however inconsistently we must treat as one of corporate power. Though there is substantial evidence that the defendant corporation did desire to change its cumbersome title to a new and more realistic name, the evidence is overwhelming that York Corporation was created by the defendant for the primary and principal purpose of effecting a reclassification, cancelling the accumulated preferred dividends on the preferred stock, by merger with it. York Corporation was brought into being by the defendant with the purpose, intention and design of effecting that which a director of the defendant and the chairman of its committee on refinancing characterized as a " 'paper' merger". As we have said, this is the point of difference between the facts of the instant case and those in Havender. Corporation Bond & Share Company, though it was a totally owned and inactive subsidiary of Federal United Corporation, was not brought into existence by Federal United for the purpose of a merger. No case has been

before the courts of Delaware which involved this precise question. In the Havender case, however, Chancellor Wolcott delivered a dictum which is most pertinent.

Chancellor Wolcott said, 2 A.2d 147, "I am of the opinion that the merger was not conceived in any genuine purpose which mergers are designed to serve. Its object and aim was to reclassify the defendant's shares in a manner which the Supreme Court of this State has declared to be not permissible. If what the defendant did will stand the test of legal legitimacy, I can see no escape from the proposition that all a corporation needs to do to escape the results of the law as laid down by our Supreme Court, is to create a subsidiary for itself and then proceed to absorb it by merger. If it be said that deliberation to evade would be too conspicuous in that case to warrant overlooking it, the answer is that evasion cannot be any the more objectionable simply because it might be a little more conspicuous. The difference between using a wholly owned subsidiary already existing and using one specially created for the purpose to accomplish by a merger an end which bears no perceptible relation to the problem involved in and incidental to the merging operation, is a difference which rests on no basis of substance."

The late great Chancellor wrote with prescience. What he said stands as the only direct evidence as to the law of Delaware today upon the question before us. The conclusion is inescapable that he was correct in his statement. Further evidence as to the law of Delaware, though it is of an indirect nature is supplied by the opinion of the Supreme Court in the appeal in the Havender case. The literal application of the phrases of Section 59 of the General Corporation Law by the Supreme Court will permit and enable a Delaware corporation to effect a reclassification which will cancel the accumulated dividends on preferred stock by merger with an inactive wholly owned subsidiary specially created for that purpose. Between inactive Corporation Bond & Share Company, not created for the purpose of merger, and inactive York Corporation, created for the purpose of merger, there is little to choose. The Keller case remains a landmark in the law of Delaware only to signify that what cannot be done directly under Section 26 of the General Corporation Law may be done by subterfuge under Section 59. A court of the United States bound by the rule of Erie R. Co. v. Tompkins is powerless to afford aid to the stockholder until reclassification reaches that degree of unfairness where it amounts to a cancellation of the preferred stockholders' accumulated unpaid dividends without adequate compensation therefor under the law, either by way of a share in the equity of the surviving corporation or by the payment of money under Section 61 of the General Corporation Law. At such a point a court of the United States might grant injunctive relief under the provisions of the Fourteenth Amendment. Such is not the situation in the case at bar, for as we have stated the plan is fair.

Accordingly the judgment of the court below is affirmed.[66]

[66] Cert. den., 325 U.S. 886, 65 S.Ct. 1573, 1945.

6. RIGHT OF APPRAISAL OF NON-ASSENTING STOCKHOLDER

NEW YORK STOCK CORPORATION LAW

§ 21. *Determination of value of stock of objecting stockholder.* In the event that the stockholders of a corporation have taken action pursuant to sections fourteen, twenty, thirty-six, eighty-five, eighty-six or ninety-one and if any stockholder has objected to such action and demanded payment for his stock as provided in section fourteen, section twenty, subdivision nine of section thirty-eight, subdivision seven of section eighty-five, section eighty-seven or section ninety-one, either such stockholder or the corporation may apply upon eight days' notice to the other, within sixty days after such demand, to the supreme court at any special term thereof held in the judicial district in which the office of such corporation is situated, for the appointment of three persons to appraise the value of such stock, and the court shall appoint three such appraisers and designate the time and place of their first meeting, with such directions in regard to their proceedings as shall be deemed proper. The court may at the time of appointing the appraisers or at any subsequent time direct such stockholder to submit his stock certificate to the clerk of the court for notation thereon of the pendency of the appraisal proceedings, and if such stockholder fails to comply with such direction the court may on motion of the corporation dismiss the proceeding. The court may fill any vacancy in the board of appraisers occurring by refusal or neglect to serve or otherwise. The appraisers shall meet at the time and place designated, and after being duly sworn honestly and faithfully to discharge their duties, they or any two of them shall estimate and certify the value of such stock just prior to the taking of the action to which the objection is made and deliver one copy of their appraisal to such corporation, and another to such stockholder if demanded by him. Either the stockholder or the corporation may apply to the supreme court upon five days' notice for an order confirming or modifying or rejecting the appraisal. If the court confirms or modifies such appraisal it shall award interest on the value of such stock, as determined by such appraisal and as confirmed or modified by the court, from the date of taking the action to which the objection was made, and shall direct the manner in which payment shall be made to such stockholder. Before receiving payment such stockholder shall surrender to the corporation his certificate of stock. When the corporation shall have paid the amount of such appraisal, as directed by the court, such stockholder shall cease to have any interest in such stock and in the corporate property of such corporation and such stock may be held or disposed of by such corporation. The fees and expenses of the appraisers shall be fixed by the court and paid by the corporation.

§ 87. *Rights of dissenting stockholders.* Any stockholder not voting in favor of such consolidation may at any time prior to the vote on such consolidation—or if notice of the meeting to vote on such consolidation was not mailed to him at least twenty days prior to the taking of such vote, then within twenty days after the mailing of such notice—object to such consolidation and demand payment for his stock. Such stockholder or such consolidated corporation shall have the right, subject to the conditions and provisions of section twenty-one to have such stock appraised and paid for as provided in said section. Such objection and demand must be in writing and filed with the constituent corporation of which he is a stockholder or with the consolidated corporation. If the consent to such consolidation is given in writing without a meeting by the stockholders of any constituent corporation the time of a stockholder of such constituent corporation to file his objection and demand shall expire on the twentieth day after the mailing to such stockholder of a notice setting forth the plan of consolidation and stating that the consent in writing of the stockholders entitled to vote thereon of such constituent corporation has been given to such consolidation pursuant to section eighty-six.

DELAWARE GENERAL CORPORATION LAW

Sec. 61. *Consolidation or Merger; Payment for Stock of Dissatisfied Stockholder:*—If any stockholder in any corporation of this State consolidating or merging as aforesaid, who objected thereto in writing and whose shares were not voted in favor of such consolidation or merger, and who filed such written objection with the corporation before the taking of the vote on such consolidation or merger, shall within twenty days after the date on which the agreement of consolidation or merger has been filed and recorded, as aforesaid, demand in writing, from the corporation resulting from or surviving such consolidation or merger, payment for his stock, such resulting or surviving corporation shall, within thirty days after the expiration of said period of twenty days, pay to him the value of his stock on the date of the recording of said agreement of consolidation or merger, exclusive of any element of value arising from the expectation or accomplishment of such consolidation or merger. If during said period of thirty days the corporation and any such stockholder fail to agree as to the value of such stock, any such stockholder, or the corporation resulting from or surviving such consolidation or merger, may by petition filed in the Court of Chancery within four months after the expiration of said period of thirty days demand a determination of the value of the stock of all such stockholders by an appraiser to be appointed by the Chancellor.

Upon the filing of any such petition by a stockholder, service of a copy thereof shall be made upon the corporation, which shall with-

in ten days after such service file in the office of the Register in Chancery in which said petition was filed a duly verified list containing the names and addresses of all stockholders who have demanded payment of their shares and with whom agreements as to the value of their shares have not been reached by the corporation. If the petition shall be filed by the corporation, the petition shall be accompanied by such a duly verified list. The Register in Chancery shall give notice of the time and place fixed for the hearing of such petition by registered mail to the corporation and the stockholders shown upon said list at the addresses therein stated, and notice shall also be given by publishing a notice at least once a week for two successive weeks, the second publication to appear at least one week before the day of the hearing, in a newspaper of general circulation published in the City of Wilmington, Delaware. The Court shall have power to direct such additional publications of notice as it may deem advisable. The forms of the notices by mail and by publication shall be approved by the Court.

After the hearing of such petition the Court shall determine the shareholders who have complied with the provisions of this section and become entitled to the valuation of and payment for their shares, and shall appoint an appraiser to determine such value. Such appraiser shall have power to examine any of the books and records of the corporation the stock of which he is charged with the duty of valuing, and he shall make a determination of the value of the shares upon such investigation as to him may seem proper. The appraiser shall also afford a reasonable opportunity to the parties interested to submit to him pertinent evidence on the value of the shares. The appraiser, also, shall have such powers and authority as may be conferred upon Masters by the Rules of the Court of Chancery or by the order of his appointment.

The appraiser shall determine the value of the stock of the stockholders adjudged by the Chancellor to be entitled to payment therefor and shall file his report respecting such value in the office of the Register in Chancery and notice of the filing of such report shall be given by the Register in Chancery to the parties in interest. Such report shall be subject to exceptions to be heard before the Court both upon the law and facts. After hearing exceptions to the said report the Court shall by its decree determine the value of the stock of the stockholders entitled to payment therefor and shall direct the payment of such value to the stockholders entitled thereto by the resulting or surviving corporation upon the transfer to it of the certificates representing such stock, which decree may be enforced as other decrees in the Court of Chancery may be enforced, whether such resulting or surviving corporation be a corporation of this State or of any other State of the United States of America. The shares of the surviving or resulting corporation into which the shares of such dissenting stockholders would have been converted had they assented

to the consideration or merger shall have the status of authorized and unissued shares of the surviving or resulting corporation, as the case may be.

The cost of any such appraisal, including a reasonable fee to and the reasonable expenses of the appraiser, but exclusive of fees of counsel or of experts retained by any party, may on application of any party in interest be determined by the Chancellor and taxed upon the parties to such appraisal or any of them as may appear to be equitable, except that the cost of giving the notice by publication and by registered mail hereinabove provided for shall be paid by the corporation.

Any stockholder who shall have demanded payment of his stock as herein provided shall not thereafter be entitled to vote such stock for any purpose or be entitled to the payment of dividends or other distribution on said stock (except dividends payable to stockholders of record at a date which is prior to the date of the recording of said agreement) unless the appointment of an appraiser shall not be applied for within the time herein provided, or the proceeding be dismissed as to such stockholder, or unless such stockholder shall with the written approval of the corporation deliver to the corporation a written withdrawal of his objections to and an acceptance of such consolidation or merger, in any of which cases the right of such stockholder to payment of his stock shall cease.

At the time of appointing the appraiser or at any time thereafter the Court may require the dissenting stockholders to submit their certificates of stock to the Register in Chancery for notation thereon of the pendency of the appraisal proceedings, and if any stockholder fails to comply with such direction the Court may dismiss the proceedings as to such stockholder.

This section shall apply only to cases of agreements of consolidation or merger filed after the date of the approval of this Act.* All prior cases shall be governed by the law in force immediately prior to the approval of this Act, which as to such cases, and only such cases, is continued in force and effect.

COLE v. WELLS et al.

Supreme Judicial Court of Massachusetts, 1916. 224 Mass. 504, 113 N.E. 189.

Suit by Alfred E. Cole, administrator, against Channing M. Wells and others. From interlocutory decrees overruling defendant's demurrer to the original bill on all grounds except that of multifariousness, plaintiff appealed, but subsequently amended, to which defendants filed a demurrer and plea. On report from the superior court Order on demurrer to bill and amended bill affirmed, and plea adjudged insufficient.

Bill in equity by a stockholder in the American Optical Company to set aside certain transactions of defendants, a majority of the officers and shareholders of the corporation, and for an accounting

* April 15, 1943.

In the superior court, the case was reported to the Supreme Judicial Court.

BRALEY, J. The bill, as originally framed, charged the defendants as directors with having wrongfully appropriated funds of the corporation to a large amount for their own personal benefit, and also that at a meeting of the stockholders duly called to take action on a plan proposed by the directors to transfer all the assets of the corporation to themselves as trustees to hold under the declaration of trust, a copy of which is annexed to the bill, the plaintiff representing a minority of the capital stock having voted against the transfer thereafter made a demand in writing upon the corporation in accordance with the provisions of St.1903, c. 437, § 44, which read as follows:

"A stockholder in any corporation which shall have duly voted to sell, lease or exchange all its property and assets or to change the nature of its business in accordance with the provisions of section 40, who, at the meeting of stockholders, has voted against such action may, within thirty days after the date of said meeting, make a demand in writing upon the corporation for payment for his stock. If the corporation and the stockholder cannot agree upon the value of the stock at the date of such sale, lease, exchange or change, such value shall be ascertained by three disinterested persons, one of whom shall be named by the stockholder, another by the corporation and the third by the two thus chosen. The finding of the appraisers shall be final, and if their award is not paid by the corporation within thirty days after it is made, it may be recovered by the stockholder from the corporation in an action of contract. Upon payment by the corporation to the stockholder of the agreed or awarded price of his stock, the stockholder shall forthwith transfer and assign the stock certificates held by him at, and in accordance with, the request of the corporation."

But having as he further alleges made the demand before he had any knowledge of the misappropriation by and fraudulent management of the directors, he also sought to maintain the suit as a minority stockholder. * * *

A minority stockholder if he votes against the action taken by the corporation is entitled under the statute "to payment for his stock." If the corporation and the stockholder cannot agree, the value is to be ascertained by disinterested arbitrators. It is obvious that "the value of the stock" means not merely the market price if the stock is traded in by the public, but the intrinsic value, to determine which all the assets and liabilities must be ascertained. The stockholder as well as the arbitrators, if arbitrators are appointed, ordinarily must resort to the books of the corporation for information, although a condition of affairs may exist where the books of themselves would fail to exhibit the true financial condition of corporate affairs. It is specifically alleged that the directors holding nearly four-fifths of the capital stock, while the plaintiff held the remaining shares, in violation of the by-laws voted themselves salaries "grossly exorbitant and greatly in excess of the fair value of the services rendered," and that not only were such misappropriations concealed from the stockholders

including the plaintiff, but being in complete control of the corporation, they managed its affairs for their own personal profit, and the books of the company were so manipulated and falsified, that it was "difficult, if not impossible, to determine from the accounts of the concern the amounts so overdrawn" or appropriated.

A further and important allegation appears, that "because of such acts your complainant did not know what the profits of the company were and was totally ignorant of the fact that these enormous salaries had been taken from the profits of the concern and remained in ignorance thereof until some time after the attempted sale," meaning the transfer under the declaration of trust. And these allegations not being contradicted by the plea are admitted to be true. French v. Shotwell, 5 Johns.Ch. (N.Y.) 555; 10 R.C.L.Equity, § 223.

The statutory option given to a dissatisfied stockholder is either to acquiesce or accept the fair value of his stock and retire from the corporation. If he retires the valuation on which payment is to be made is not what the majority stockholders may be willing the corporation should pay, but is to be ascertained as if liquidation had been voted and all the corporate property after the payment of debts had been marshaled for the benefit of all the stockholders. It is plain that the defendants through their control of the corporation cannot compel the plaintiff who was ignorant of their misdoings, to accept payment for his stock upon a valuation of the assets which excludes the amounts misappropriated. A demand under such circumstances cannot be held to have the force and effect of the demand contemplated by the statute, and there was no irrevocable election as the defendants contend to receive payment upon a valuation to be fixed by agreement of parties, or by arbitration, whereby all demands for an accounting or proceedings to set aside the transfer as violative of his just rights as a dissenting or minority stockholder were waived. The right moreover to demand payment and the right to seek relief in equity in aid of the demand, are not inconsistent but concurrent, and under such circumstances there is no necessity for an election. Mason v. Mason, 4 Sandf.Ch. (N.Y.) 623, 632; Barnett v. Philadelphia Market Co., 218 Pa. 649, 67 Atl. 912; Winfree v. Riverside Cotton Mills, 113 Va. 717, 724, 75 S.E. 309.

But even if the plaintiff could be deemed to have elected, he remained a stockholder until payment by the corporation for his stock at the agreed or awarded price, with the right if necessary to maintain a minority stockholder's bill for an accounting and the restoration to the corporation of the unlawful gains and profits obtained by the defendants while acting in a fiduciary capacity. The enhancement of assets from this source manifestly would result in the enhancement of the price or value of his stock.

The bill alleges that, the defendants having acquired virtual ownership and control of all the stock of the corporation excepting the small percentage owned by the plaintiff, they caused a meeting of the stockholders to be called to take action with reference to selling or disposing of all the assets and business of the company, and the vote thereupon passed that the company sell all its property and assets

including its good will to the defendants to hold and manage under the declaration of trust was not intended to be a transaction in the interests of the corporation and the stockholders, but was deliberately planned and accomplished for the sole purpose of enabling the defendants to acquire for their own benefit the property of the corporation, and to protect and secure themselves against any attempt on the part of the corporation, or of the plaintiff to seek and compel an accounting of the moneys theretofore wrongfully appropriated, and to enable them to enlarge and carry on the business beyond the chartered powers of the company solely for their own personal advantage, as well as to retain under the guise of a trust with certificates of preferred and common stock a greater share of the profits than they would have obtained if the transfer had not been made. A transaction of this character promoted and consummated by the directors who were also the majority stockholders was a deliberate fraud upon the corporation, and the plaintiff. The vote and transfer cannot bar the right of a dissentient stockholder who has no remedy within the corporation because the wrongdoers are in full control, from maintaining a bill in equity in its behalf to have the transfer set aside and for an accounting. The property and profits when recovered constitute assets of the corporation. Brewer v. Boston Theatre, 104 Mass. 378; Greenfield Savings Bank v. Simons, 133 Mass. 415; Warren v. Para Rubber Shoe Co., 166 Mass. 97, 44 N.E. 112; Von Arnim v. American Tube Co., 188 Mass. 515, 74 N.E. 680; United Zinc Cos. v. Harwood, 216 Mass. 474, 476, 103 N.E. 1037, Ann.Cas.1915B, 948; Smith v. Bank of Victoria, 41 L.J. (P.C.) 34; 7 R.C.L. Corporations, §§ 287, 609.

The result is that the interlocutory decrees overruling the demurrer to the original bill on all grounds except for multifariousness, and the demurrer to the amended bill, and adjudging the plea to be insufficient in law from which the defendants appealed, are affirmed.

Ordered accordingly.

ADAMS et al. v. UNITED STATES DISTRIBUTING CORPORATION et al.

Supreme Court of Appeals of Virginia, 1945. 184 Va. 134, 34 S.E.2d 244.

Appeals from Law and Equity Court of City of Richmond; Willis D. Miller, Judge.

Suit in equity by Maurice D. Adams and others against United States Distributing Corporation, the Pittston Company, and others for determination of rights of plaintiffs as dissenting holders of preferred stock of first-named defendant and that plaintiffs should be paid amounts alleged to be due them, wherein the last-named defendant filed a demurrer, and after the demurrer was overruled the last-named defendant filed a cross-appeal. From a decree plaintiffs appeal and last-named defendant cross-appeals.

Reversed and dismissed.

EGGLESTON, JUSTICE. This appeal involves the rights of certain holders of preferred stock in United States Distributing Corporation, a

Virginia corporation, with its principal office in the city of Richmond, who dissented from the merger of that corporation with The Pittston Company, a Delaware corporation, under the name of the latter. The merger was approved by the respective agencies of the two States on December 31, 1942, with the result that the merged corporation is now duly incorporated in both States. * * *

Briefly stated, the appellants' position is, that the merger of United States Distributing Corporation into The Pittston Company resulted in the dissolution of the former corporation, which gave to the dissenting stockholders their choice of three courses of action:

(1) They could join in the merger by exchanging their stock for shares in the continuing corporation.

(2) They could proceed under Code, § 3822, to recover the "fair cash value" of their stock.

(3) They could insist that the continuing corporation, The Pittston Company, pay to them out of the assets it received from the United States Distributing Corporation the par value of their stock, plus accrued dividends thereon, provided The Pittston Company received from the United States Distributing Corporation sufficient assets for such purpose.

It is the position of The Pittston Company that Code, § 3822, as it stood at the time of the merger, gave the appellants the choice of only the first two alternatives, contended for by them, but that it left to them no right to the third course which they are attempting to assert in the present proceeding. * * *

We are of opinion that these provisions evidence a clear legislative intent, not present in the 1903 statute, to give every stockholder of a merging corporation an election either to dissent and secure in the prescribed manner the fair cash value of his stock, or, if he fails to dissent, to be bound by the terms of the merger.

There is no language, either express or implied, on which there may be based the third alternative remedy which the appellants have sought to invoke in this proceeding.

Nor can the right to such remedy be based on anything which was said in Winfree v. Riverside Cotton Mills, supra. While the opinion states that the dissenting stockholder, in an independent suit in equity, is entitled to receive not less than the "actual value" of his shares, that term is practically synonymous with "fair cash value." Certainly, there is no suggestion that the dissenter may recover what the appellants here call the 'contractual value" of their shares as distinguished from the "fair cash value" or the "actual value." See, Weiss v. Routh, post.

To adopt the contention of the appellants and hold that the remedy afforded by the statute is merely cumulative and not exclusive would lead to confusion and to inequitable results among various dissenting stockholders, even where the identical corporation is involved and the sole question is that of the value of the dissenters' shares. For example, in the case at bar, those preferred stockholders, other than the appellants, who dissented from the merger and pursued the statutory remedy for the appraisal of the "fair cash value" of their stock, in the

Chancery Court of the city of Richmond, would have such value determined by the appraisers appointed by that court and subject to its approval, while the appellants in the present proceeding would have the value of their stock determined by a commissioner in chancery, subject to the approval of the Law and Equity Court of the city of Richmond. Unless the two tribunals worked in close harmony they might arrive at entirely different results, although the ultimate purpose is precisely the same.

But that is not all. If the appellants are sound in their view, then they would be free to pursue their equitable remedy in any court, State or Federal, in which they might acquire jurisdiction of the parties. Under this theory the dissenting stockholders could institute actions for the value of their shares in State and Federal courts throughout the country, provided, only, that proper service of process could be effected.

If such a multiplicity of suits could be instituted, and if all such courts had equal and concurrent jurisdiction, the inescapable result would be that instead of all dissenters from a particular merger receiving equal treatment, those who elected to pursue different remedies or like remedies in different courts, would inevitably find themselves with widely varying judgments in their favor. See, Weiss v. Routh, post.

It is inconceivable, we think, that the legislature ever intended that dissenting stockholders of the same corporation and of the same class should receive different values for their shares. On the contrary, we think the design of the Virginia statute is to assure to the dissenting stockholder that he will be fully compensated for the value of that of which he has been deprived by the merger, and no more. * * *

The appellants argue that the effect of the merger and the application of the terms of the appraisal statute is to violate the contract which they had with the corporation, as embodied in its charter and in the provisions of the certificates of stock held by them. There are two answers to this contention.

In the first place, it is elementary that the general corporation law of the State, in force at the time of the incorporation, is just as much a part of the contract between the corporation and its stockholders as are the documents upon which the appellants rely. [Citing Cases.] * * *

Indeed, Code, § 3841, provides: "The general statutes of this State applicable to corporations shall be a part of the charter of every corporation formed under the laws of this State, except so far as the same are inapplicable or inappropriate to the objects of such corporation."

Therefore, when the appellants invested in the shares of the United States Distributing Corporation, they did so with the full knowledge of the fact that the corporation, chartered under the General Corporation Law of Virginia, in 1919, might, under the laws of this State, merge with another corporation, in the manner and with the effect upon their investment specified in the statute.

In the next place, the appellants' claim is predicated upon the theory that the merger of United States Distributing Corporation into The

Pittston Company effected a dissolution of the former corporation and thus made operative the charter provision that, "in case of the liquidation or dissolution of this corporation, or a distribution of its assets," the preferred stockholders were to be paid the par value of their stock, plus accrued dividends.

Whether a merger results in the dissolution of the constitutent corporations depends upon the terms and intent of the statute involved. 13 Am.Jur., Corporations, § 1195, pp. 1097, 1098; Fletcher Cyclopedia Corporations, Perm.Ed., Vol. 15, § 7076, pp. 74, 75.

It is well settled in this State that the merger of two corporations does not end the existence of either, but continues the existence of both in the merged corporation. * * *

Reversed and dismissed.[67]

In re CLARK'S WILL.

In re FULTON.

Court of Appeals of New York, 1931. 257 N.Y. 487, 178 N.E. 766.

Proceeding by Kerwin H. Fulton, as substituted trustee under the last will and testament of Alexander Clark, deceased, for the appointment of persons to appraise the value of the shares of stock held by petitioner in the Van Beuren & New York Billposting Company. From an order, 237 N.Y.S. 745, which affirmed an order of the Special Term, 131 Misc. 151, 226 N.Y.S. 141, confirming the report of appraisers the Van Beuren & New York Billposting Company appeals.

Modified and affirmed.

HUBBS, J. This is a proceeding to appraise the value of 481 shares of the preferred stock of Van Beuren & New York Billposting Company, under section 21 of the Stock Corporation Law (Consol. Laws, c. 59).

All of the stockholders of the appellant corporation, except respondent, voted to sell and transfer all of its assets, including its good will, to another corporation. The respondent, who owned 481 shares of preferred stock, did not vote in favor of such sale. He commenced this proceeding under section 21 of the Stock Corporation Law to have the value of his stock appraised. The par value of his stock was $100 per share, and it had never sold above par.

At the date of the respondent's dissent, there were outstanding 2,471 shares of 6 per cent. preferred and 2,471 shares of common stock, all of the par value of $100 per share. The corporation had therefore capital stock outstanding totalling $494,200, all of which had been issued at par. It also had an accumulated surplus arising from undivided profits totaling $682,757.95. The appraisers fixed the value of the preferred stock at $238.15 per share. That figure was arrived at by dividing the sum of the surplus and capital stock issued, $1,176,-957.95, by 4,942, the total number of shares issued, common and preferred. Thus one-half of the surplus was allotted to the preferred stock.

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[67] Cert. den., 327 U.S. 788, 66 S.Ct. 807, 1946.

If the method adopted by the appraisers was correct, it is quite apparent that the respondent, by dissenting and requiring an appraisal of his stock, thereby more than doubled the value of his stock which had never sold for more than par.

The method adopted by the appraisers was the method approved for the appraisal of preferred stock after a dissolution of a corporation in the case of Continental Insurance Co. v. United States, 259 U.S. 156, 42 S.Ct. 540, 66 L.Ed. 871. We do not pass upon the question of the proper rule to be applied upon the distribution of surplus between common and preferred stock upon the dissolution of a corporation. The determination of that question is not involved in this case.

Under section 21 of the Stock Corporation Law, the duty of the appraisers is to "estimate and certify the value of such stock at the time of such dissent." We are required to determine the proper method of computing the "value" of each share of preferred stock on April 13, 1926, "the time of such dissent."

Proceedings to dissolve a stock corporation in this state are carefully regulated by statute, which prescribes in great detail all of the various steps in such proceeding. Article 7 of chapter 28, Laws of 1909, the General Corporation Law (Consol. Laws, c. 23), regulates the proceedings for an involuntary dissolution, and article 9 thereof applies to a voluntary dissolution. Section 185 of the statute as amended (Laws 1929, c. 650) provides for the division of the surplus among the stockholders, after the payment of claims, "in accordance with their respective interests." Manifestly, their "respective interests" will depend upon the provisions of the certificate of incorporation and the wording of the stock certificates. In the absence of any provision giving a preference in the surplus to a particular class of stock, it has been decided that such surplus shall be distributed "upon principles of equal justice and equity among all the stockholders." James v. Woodruff, 10 Paige, 541, 546, affirmed 2 Denio, 574.

At the time of the distribution of a surplus upon dissolution, the directors of a corporation have ceased to function. The title to the surplus has vested in a receiver. The statute requires him to distribute it to the stockholders "in accordance with their respective interests."

This proceeding has no resemblance to an action or proceeding to dissolve a corporation. It is a purely statutory proceeding. The statute expressly provides for the fixing of the value of the stock of a going concern, as of the time of the dissent.

It has been said that a sale, not in the ordinary course of business, by a corporation of a substantial part of its business, "so integral as to be essential for the transaction of its ordinary business" (Matter of Timmis, 200 N.Y. 177, 181, 93 N.E. 522, 523), entitles dissenting stockholders to have their stock appraised and paid for by the corporation. The statement that such a sale constitutes a "practical dissolution" of a corporation has been used, not to indicate that the corporation as such had ceased to exist, but as a justification for holding that such a sale could not be made over the protest of dissenting stockholders without giving them the right to have their stock appraised.

While the sale of the assets of a corporation changes the character of the business of the vendor corporation, and establishes the right of a dissenting stockholder to have his stock appraised, it does not amount to an actual dissolution.

Matter of Timmis, 200 N.Y. 177, 93 N.E. 522, is a typical case. In that case a substantial branch of the corporation's business was sold, not in the ordinary course of business, and this court decided that the dissenting stockholder was entitled to have his stock appraised, not because the corporation was dissolved, but because the stockholder could not be compelled to continue as a stockholder in a substantially different business. A reading of the opinion in that case discloses that the corporation was not in fact dissolved or its business discontinued. It only discontinued one branch of its business and continued to carry on its other branches.

At common law, the assets of a corporation could not be sold without the consent of all stockholders. The right of two-thirds of the stockholders to require a sale is a privilege conferred by the Legislature. That privilege cannot be exercised to the detriment of the dissenting stockholders. To require them to accept less than a fair market price for their stock would be a distinct injury. It is true that there may be cases where the stock has a fictitious market price. To require the corporation in such cases to pay the market price of the stock owned by dissenting stockholders would work a hardship on the corporation and its remaining stockholders.

Under such circumstances the market quotations should be considered, but not accepted as decisive of a fair market price. The market quotations at the time of the dissent may, in certain instances, reflect an expectation of increased value as a result of the proposed sale. A dissenting stockholder is not entitled to share in an enhanced value of stock due to the sale which he has opposed and from which he dissents. Market quotations are therefore to be considered only in so far as they reflect a reasonable basis for estimating market quotations which would probably have continued if a sale had not been made. The appraisers should consider the elements that tend to affect market quotations: The rate of dividends; the regularity with which they have been paid; the management and reputation of the company; its prospects for the future; and all other circumstances which will aid them in estimating the future course of the stock in the market. After such consideration, it may be reasonable to decide that the true market price of the stock, i. e., the quotations that would probably prevail in the future, is not less than the quotations at the time of the dissent, and an award may be made based on such market quotations even though it would be greater than the book value or the value as estimated by experts.

The consideration of market quotations when they have been artificially enhanced will seldom be required upon an appraisal, for, if there is an open unrestricted market in which dissenting stockholders can sell their stock at more than its actual value, they will, no doubt, do so. If, however, the directors of the corporation have so managed it as to depress the price of the stock in the open market, dissenting stock-

holders will naturally desire to secure for their stock its actual value by requiring an appraisal. Petry v. Harwood Electric Co., 280 Pa. 158, 124 A. 307.

The payment of such actual value, even if more than the market quotation, is the price that must be paid by the corporation for the privilege of requiring a sale over the protest of the dissenting stockholders who in effect are being ousted from the corporation.

The purpose of the statute being to save the dissenting stockholder from loss by reason of the change in the nature of the business, he is entitled to receive the value of his stock for sale or its value for investment.

No rule can be laid down for determining the actual or true value of stock of a given class except one of a very general nature, and which may, in a particular case, be inapplicable because of varying provisions contained in the charter or by-laws of the corporation or because of the existence of a state of facts peculiar to the situation involved in the particular case.

In addition to the aliquot value of the share of the applicable assets, which is the only factor to consider under the facts in this case, and market quotations, other elements should be considered by the appraisers. Those elements will necessarily vary in different cases, and it is not practical to attempt to state every circumstance which may properly influence appraisers in fixing the value of such stock.

It will be readily appreciated that the appraisers should have considered the investment value of the stock which is largely determined by the rate of return, the security afforded that the dividends will be regularly paid, the possibility that dividends will be increased or diminished, the selling price of stocks of like character, the amount of preferred stock in comparison with the common stock, the size of the accumulated surplus applicable to the payment of dividends, the record of the corporation, and its prospects for the future.

The appraisers in estimating the fair value of the stock being appraised should give such consideration as to them seems proper to each factor which might enter into such value, and their report as to value should be reasonable and in accordance with the facts proven.

In the case at bar the directors had not ceased to function. The corporation was a going concern. The surplus, consisting of accumulated profits, was still subject to distribution among the common stockholders. True, the corporation had voted to go out of the active business in which it had been engaged and to turn over its assets to another corporation, and to receive therefor stock in the purchasing company, but the relation of the nondissenting stockholders to the vendor corporation remained unchanged. Under the proposed transfer, the stock of the purchasing company received in exchange was to become assets of the selling company and held by its directors in place of the assets which had been transferred. There is no apparent reason why the directors could not vote that part of the stock acquired in exchange for the surplus profits of the corporation as a stock dividend to the holders of the common stock, or sell such stock and distribute the proceeds as a cash dividend to the common stockholders. The holders

of the preferred stock had no interest in such surplus except the preference given by the terms of the certificate of incorporation, which gives a preference as to dividends only.

The appraisers were mistaken in assuming that the dissenting stockholder was entitled to an aliquot part of the surplus earnings of the company and in apportioning the same to his preferred stock. The result was to give an unreal and fanciful value to his preferred stock, and to work an injustice to the common stockholders and to the holders of the remaining preferred stock. As there was no established market for the preferred stock, the respondent was entitled to receive the actual value of his stock. The figures used by the appellant showing the condition of the corporation were all taken from its last balance sheet and are conceded to be correct. The correct method of computing the value of the preferred stock under the conceded facts is comparatively simple. The capital stock account was made up of the amount paid for the stock when issued at par; i. e., $494,200. That amount divided by the number of shares issued equals the value of each share of preferred stock, the value at which it should have been appraised under the facts in this case. It happens to be the exact amount paid for the stock when issued.

The result that the dissenting preferred stockholder is entitled to receive for his preferred stock the exact amount paid occurs because the corporation commenced business without any surplus and each stockholder paid par for his stock when issued.

The cases relied upon by the respondent do not hold anything contra to the conclusion which we have reached. Continental Insurance Co. v. United States, supra, involved the construction of a certificate of incorporation which by its terms defined the rights of holders of preferred stock. The court decided that the holders of such stock were entitled to share in the surplus at the conclusion of an action to dissolve the corporation. The dicta contained in the case of Cole v. Wells, 224 Mass. 504, 113 N.E. 189, states the rule applicable upon the distribution of a surplus among owners of common stock, and has no application to a case where a surplus is to be distributed in a statutory proceeding where there is outstanding stock, both common and preferred.

It will be unnecessary to remit the proceeding for a reappraisal, as the parties are in substantial agreement that the value of the preferred stock is its par value of $100 per share provided the dissenting holder of preferred stock is not entitled to share in the surplus.

The order should be modified by reducing the amount to be paid by the appellant for the 481 shares of preferred stock owned by the respondent from the sum of $114,515.50 to $48,100, and, as modified, affirmed, without costs.

ANDERSON v. INTERNATIONAL MINERALS & CHEMICAL CORPORATION.

Court of Appeals of New York, 1946. 295 N.Y. 343, 67 N.E.2d 573.

[For statement of facts, see supra p. 613.]

* * * In this case we are dealing with the provisions of the New York Stock Corporation Law having to do with merger and consolidation (art. 8). These provisions differ in language, purpose and subject matter from article 4 relating to the reclassification of shares under which the cases arose upon which plaintiff relies. The whole process of merger and consolidation rests upon the principle of permitting consolidations approved by two thirds of the shareholders which in the absence of Statute would require the consent of all and permitting dissenters, not wishing to go along, to retire from the enterprise upon payment to them of the appraised value of their shares. It is important to note that the provisions of subdivision 7 of section 91 of article 8 give to every dissenting stockholder included in the consolidation the right to object and demand payment for his stock and to have the same appraised and paid for in the manner provided and subject to the conditions imposed by section 21. Section 21 expressly provides: "Before receiving payment such stockholder shall surrender to the corporation his certificate of stock. When the corporation shall have paid the amount of such appraisal, as directed by the court, such stockholder shall cease to have any interest in such stock and in the corporate property of such corporation and such stock may be held or disposed of by such corporation."

The purpose of section 21 of the Stock Corporation Law was to protect dissenting shareholders, and the process of appraisal was designed to meet two evils which arose because of limitations upon the powers of majority shareholders to bind the minority to a course of action beyond the powers of the majority, which might well be greatly to the advantage of those engaged in a corporate enterprise. These two evils are well stated in Matter of Timmis, 200 N.Y. 177, at page 181, 93 N.E. 522 at page 523 dealing with analogous Statute.

"(1) The injustice to the bulk of the stockholders from want of power in a corporation to sell its business or an essential part thereof to another corporation organized for the purpose, frequently from its own membership, on terms deemed advantageous by the holders of a large majority of the stock. (2) The injustice to minority stockholders of requiring them to abandon, change, or limit their business if the majority should have the power to direct such a sale. An incidental evil was the power of a dissenting stockholder to compel the majority to buy him out on his own terms in order to secure unanimous consent with no one left to question the transaction.

"These evils could be remedied only by legislation, for the courts cannot provide against inherent defects in the creation of corporations. * * * This legislation was designed to meet the evils pointed out by the courts by enabling a majority of two-thirds to sell if they deemed

it was the best policy, and at the same time to protect the minority, if they regarded the sale as opposed to their interests."

The remedy of appraisal and payment was intended to afford fair and just compensation to the dissenters and at the same time provide the method by which their objections could be fairly composed so as to enable the consolidation to proceed. This is plainly one of the cases in which it was intended that the rights of the dissenting minority should be surrendered, subject only to their right, secured by the statute, to fair and just compensation. No other construction of the statute is compatible with the accomplishment of its purpose. The care with which the Legislature provided in such cases that any stockholder included in the consolidation can have such compensation indicates quite clearly that every right of a dissenting shareholder is to be appraised and paid for. Since consolidation necessarily imports the retirement of the stock of the constituent companies and the issuance of new shares representing the capital of the consolidated company, the old stock with all its rights and privileges is necessarily retired and the shareholders participating in the consolidation become entitled to the shares of the new corporation under the terms and conditions of the certificate of consolidation. If, proceeding in accordance with the statute, the consolidation is duly consummated, there are but two alternative rights which survive to the holders of the old shares: To take the new shares upon the terms and conditions of consolidation or to take the value of the old shares determined in accordance with section 21. The plaintiff here insists that he may demand the dividends accumulated upon his stock and at the same time take the new shares of the consolidated company. This of course is quite contrary to the provisions of the certificate of consolidation which provides for the issuance of one share of new 4% cumulative preferred stock and three and one-half shares of new common stock of the consolidated corporation in exchange for each share of the 7% prior preference cumulative stock of the constituent New York corporation, International Agricultural Corporation. Of course none of the other shareholders has agreed to any such basis of consolidation as the plaintiff demands and his demand is destructive of the whole statutory process.

The plaintiff attempts to support his position by reference to section 90 of the Stock Corporation Law which deals with rights of creditors of consolidated corporations. Quite obviously there is no merit in this contention, for the right to accrued dividends, accrued merely by the lapse of time and not yet declared, is not a debt or a claim enforcible against the corporation, Godley v. Crandall & Godley Co., 212 N.Y. 121, 128, 105 N.E. 818, 820, L.R.A.1915D, 632; McNulty v. W. & J. Sloane, 184 Misc. 835, 842, 54 N.Y.S.2d 253, 260.

The interpretation of the statute being clear, no question arises as to its constitutional validity since the plaintiff acquired his stock in International Agricultural Corporation, a New York corporation, during the years 1931 and 1932. It is true that section 91 authorizing the consolidation of domestic with foreign stock corporations was added by Laws of 1934, chapter 611, section 1, effective May 14, 1934, but similar provisions for merger and consolidation of two or more

domestic business corporations had been on the statute books since the enactment of section 8 of the Business Corporations Laws of 1909 Consol.Laws, c. 4, and these provisions had been derived from section 14 of the Business Corporations Law of 1890. Thus whatever rights the plaintiff acquired as a stockholder in 1931 and 1932 were subject to the provisions for appraisal similar to those which he now attacks as invalid. Indeed, the constitutionality of such provisions had been considered and determined by this court as early as 1918 (Logan v. New Amsterdam Gas Co., 224 N.Y. 664, 121 N.E. 876) and similar questions arising under the Banking Law, Consol.Laws, c. 2, were decided in April, 1908. Colby v. Equitable Trust Co. of New York, 192 N.Y. 535, 84 N.E. 1111. For a precisely analogous case see In re Interborough Consolidated Corporation, D.C., 277 F. 455.

The judgment should be affirmed, with costs.

E. CORPORATE REACQUISITION OF OWN STOCK; REDEMPTION AND RETIREMENT.

NEW YORK STOCK CORPORATION LAW.

§ 28. *Redemption, purchase or retirement of preferred stock out of capital.* 1. Whenever any stock corporation has issued shares of any class of preferred stock which by their terms are redeemable at the option of the corporation, and such corporation shall desire to redeem or purchase any of such shares, it may, unless otherwise provided in its certificate of incorporation or other certificate filed pursuant to law, by resolution of its board of directors, apply to the redemption or purchase thereof an amount out of its capital which shall not be greater than the capital represented by the shares so redeemed or purchased, provided that the effect of any such redemption or purchase and application of capital thereto shall not be to reduce the actual value of its assets to an amount less than the total amount of its debts and liabilities, plus the amount of its capital reduced by the amount of capital so applied. Any such redemption or purchase and application of capital thereto shall not be deemed to be the declaration or payment of a dividend or a distribution of assets within the meaning of section fifty-eight. Whenever any such stock corporation shall have in its treasury shares of any class of such preferred stock so redeemed or purchased out of capital, or redeemed or purchased out of surplus, it may, unless otherwise provided in its certificate of incorporation or other certificate filed pursuant to law, by resolution of its board of directors, retire such preferred stock. Upon the filing of a certificate as provided in paragraph three of this section, all shares so redeemed, purchased or retired shall be eliminated from the authorized capital stock or number of shares of the corporation, and the capital of the corporation shall be reduced by an amount equal to the amount so applied to the redemption or purchase of such shares or, in the case of such retirement by an amount equal to the amount of capital represented by the shares so retired.

2. For the purposes of this section:

a. When the shares so redeemed, purchased or retired have a par value, the capital represented thereby shall be deemed to be the par value thereof;

b. When such shares are without par value, the capital represented thereby shall be determined as follows:

Where any part of the capital of the corporation has not been allocated to any class of shares or consists of amounts transferred to capital by resolution of the board of directors, in determining for the purposes of this section the capital represented by such shares without par value so redeemed, purchased or retired, the board of directors may allocate to the capital represented by the class of which such shares are a part all or any part of such allocated or transferred capital. If the statement respecting capital is that prescribed by paragraph A of subdivision four of section twelve, the capital represented by the class of stock of which the shares so redeemed, purchased or retired, are part shall be the dollar amount per share specified in such statement multiplied by the total number of issued shares of such class, plus any other amount transferred or allocated to such class by the board of directors; or if the statement respecting capital is that prescribed in paragraph B of subdivision four of section twelve, the capital represented by such class shall be the aggregate amount of consideration received by the corporation for the issuance of the total number of issued shares of such class, together with any other amount transferred or allocated to such class by the board of directors; provided, that the capital represented by any class of such preferred stock shall not be greater than the maximum amount which by the terms of such stock would be distributable to all the issued shares thereof upon the involuntary liquidation of the corporation. The capital represented by each issued share of any class of such preferred stocks shall be the quotient obtained by dividing the total capital represented by such class by the total number of issued shares of such class.

3. Whenever any capital of the corporation is applied to the redemption or purchase of shares of such preferred stock or any shares of such preferred stock which have been purchased out of surplus are retired, pursuant to this section, there shall be filed a certificate which shall be entitled "Certificate of reduction of capital of (name of corporation) pursuant to section twenty-eight of the stock corporation law." Such certificate shall contain the statements prescribed in section thirty-six for like certificates under subdivision (G) to effect the reduction of capital, and the statements prescribed by such section thirty-six of like certificates under subdivision (A) or (C), as the case may be, to effect the reduction of capital stock or the elimination of previously authorized shares, except that such certificate need not state the preferences, privileges and voting powers, or restrictions or qualifications thereof, of previously authorized shares. Such certificate shall be subscribed and acknowledged by the president or a vice-president and the secretary or an assistant secretary who shall make and annex an affidavit that they have beeen authorized to execute and file such certificate by resolution of the board of directors,

adopted at a directors' meeting duly called and held on a date specified in such affidavit. There shall be annexed to such certificate an affidavit of the president or a vice-president and also an affidavit of the treasurer or a majority of the directors stating that the actual value of the assets of the corporation is not less than the total amount of the debts and liabilities of the corporation plus the reduced amount of its capital. Such certificate shall be filed as provided in section thirty-eight in respect of certificates under section thirty-six.

§ 38. * * *

9. If the certificate

(a) alters or abolishes any preferential right of any outstanding shares having preferences, affecting the holders of such shares adversely; or

(b) creates, alters or abolishes any provision or right in respect of the redemption of any outstanding shares or of any sinking fund for the redemption or purchase of any such shares, affecting the holders of such shares adversely; or

(c) limits or denies any pre-emptive right of the holders of any outstanding shares to subscribe for shares or other securities of the corporation, or alters or abolishes any provision affecting any such right contained in the certificate of incorporation or other certificate filed pursuant to law, so as to affect adversely the pre-emptive right of such holders; or

(d) abolishes any voting right of the holders of shares of any class or limits their voting rights, except as the same may be limited by the voting rights given to new shares of any class authorized by the certificate;

any holder of any such shares not in favor of such action may at any time prior to the vote authorizing such action—or if notice of the meeting to vote upon such action was not mailed to stockholders entitled to receive such notice at least twenty days prior to the taking of such vote, then within twenty days after the mailing of such notice—object to such action and demand payment for his stock, and thereupon such stockholder or the corporation shall have the right, subject to the conditions and provisions of section twenty-one, to have such stock appraised and paid for as provided in said section. Such objection and demand must be in writing and filed with the corporation. If the action is effected without a meeting, the time of such stockholder to file his objection and demand shall expire on the twentieth day after the mailing to such stockholder of a notice stating the nature of such action and the date on which a certificate pursuant to section thirty-six and executed as prescribed by subdivision two of section thirty-seven was filed. * * *

DELAWARE GENERAL CORPORATION LAW.

Sec. 19. *Corporation May Purchase, Hold, Sell and Transfer Its Own Stock; Not to be Voted:*—Every Corporation organized under this Chapter shall have the power to purchase, hold, sell and transfer shares of its own capital stock; provided that no such corporation

shall use its funds or property for the purchase of its own shares of capital stock when such use would cause any impairment of the capital of the corporation; and provided further that shares of its own capital stock belonging to the corporation shall not be voted upon directly or indirectly; and provided, further, that nothing in this Section shall be construed as limiting the exercise of the rights given by Section 27 of this Chapter.

Sec. 27. *Retirement of Perferred Stock:*—Whenever any corporation organized under this Chapter shall have issued any preferred or special shares it may, subject to the provisions of its Certificate of Incorporation, (1) redeem all or any part of such shares, if subject to redemption, at such time or times, at such price or prices, and otherwise as shall be stated or expressed in the Certificate of Incorporation or (2) at any time or from time to time purchase all or any part of such shares, but in the case of shares subject to redemption, at not exceeding the price or prices at which the same may be redeemed, or (3) at any time or from time to time, by resolution of the board of directors, retire any such shares redeemed or purchased out of surplus. The corporation may apply to such redemption or purchase an amount out of its capital which shall not be greater than the sum of (1) that part of the consideration received for such shares which shall be capital pursuant to the provisions of Section 14 of this Chapter and that part of surplus which shall have been transferred and treated as capital in respect of such shares pursuant to the provisions of said Section and (2) any amounts by which the capital of the corporation shall have been increased by other transfers from surplus in accordance with the provisions of said Section 14, except those transfers, if any, which shall have been made in respect of other preferred or special shares. No such redemption or purchase, however, shall be made out of capital unless the assets of the corporation remaining after such redemption or purchase shall be sufficient to pay any debts of the corporation, the payment of which shall not have been otherwise provided for.

Any such shares so redeemed or purchased by the application of capital or otherwise retired pursuant to the provisions of this Section, shall, upon the filing and recording of the certificate hereinafter in this Section provided for, and any shares of the corporation surrendered to it on the conversion or exchange thereof into or for other shares of the corporation pursuant to the provisions of the Certificate of Incorporation shall, after such conversion or exchange, have the status of authorized and unissued shares of the class of stock to which such shares belong; provided, however, that if the Certificate of Incorporation prohibits the reissue of such shares, the authorized capital stock of the corporation of the class to which such shares belong shall, upon such redemption, purchase, retirement, conversion or exchange, be deemed to be, and shall, upon the filing and recording of an appropriate certificate, executed as hereinafter provided, be reduced to the extent of the aggregate par value of the shares so redeemed, purchased, retired, converted or exchanged or, if such shares are without par value, to the extent of the total number of such shares.

Whenever any capital of the corporation is applied to the redemption or the purchase of shares or any shares are retired pursuant to the provisions of this Section 27, a certificate shall be made accordingly under the seal of the corporation and the hands of its President or a Vice-President and its Secretary or an Assistant Secretary and the President or such Vice-President shall acknowledge said certificate before an officer authorized by the laws of Delaware to take acknowledgement of deeds; and said certificate, so executed and acknowledged, shall be filed in the office of the Secretary of State and a copy thereof, certified by said Secretary of State, shall be recorded in the office of the Recorder of the County in which the original Certificate of Incorporation is recorded; and thereupon the capital of the corporation shall be deemed to be and shall thereby be reduced by the amount thereof so applied to such redemption or purchase or the amount thereof represented by the shares so redeemed or purchased.

NOTE

"* * * a right to redeem springs from a provision in the articles of association, by-laws or share certificate existing at the time the shares were created and obtaining with respect to all the shares of a given class. A purchase of shares, on the other hand, though it also results in a surrender of shares and a distribution of funds to the holder, is the creature of a specific agreement between the corporation and the individual holder. The obligation of the corporation to purchase does not necessarily arise at the time of issuance. * * * Another process often involving a delivery of shares to the corporation and a distribution of capital to the shareholder is a statutory reduction of capital stock. This method differs, however, from a redemption in at least one respect. It is not provided for in advance by an agreement between the corporation and its members at the time of the issuance of the shares." Note, Redemption of Preferred Shares, 1935, 83 U. of Pa.L.Rev. 888, 889.

A corporation may reacquire its stock, *without* purchase, in the following ways:

1. by taking back some outstanding stock to compromise a claim against it or a debt owed by a stockholder;
2. by bidding in outstanding shares rather than forfeiting them for non-payment of calls or assessments;
3. by a gift or bequest of shares from a stockholder;
4. by operation of law (*i. e.*, the corporation is sued for conversion; there is a judgment for plaintiff; on payment of the judgment, title to the shares vests in the corporation).

A corporation may wish to *purchase* its own stock for any one of the following reasons:

1. to effect a compromise of internal dissension; [1]
2. to repurchase from employees stock given them with an option in the company to buy in the shares at the termination of the employment; [2]
3. to permit the company, in floating stock issues, to entice otherwise reluctant buyers by contracts to repurchase from them if they later wish to back out;
4. to obtain stock which can be issued at less than par, (*i. e.*, there is no requirement that treasury stock be issued at par);

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[1] In effect, this is what the Fords did after Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668, 3 A.L.R. 413, Ford personally buying out all the stockholders so that he might operate the enterprise without opposition, see supra, f. n. 5, p. 398. See, also, 1928, 76 U. of Pa.L.Rev. 751.

[2] See, Topken, Loring, & Schwartz, Inc. v. Schwartz, infra, p. 687.

5. to perpetuate control of the enterprise without having to buy a majority of the voting stock, (*i. e.*, by buying in some outstanding voting shares for retirement, thus converting minority voting stock into a majority);

6. to prefer favored shareholders, by permitting them to withdraw from the venture either because they have lost confidence in it, or to give them an advantageous price;

7. to avoid the preemptive right of stockholders;[3]

8. to manipulate the stock market, (*i. e.*, by trading in its own securities, an artificial value is set upon the shares);

9. to defeat creditors' priorities to corporate assets in the event of insolvency. See, Levy, Purchase by a Corporation of Its Own Stock, 1930, 15 Minn.L.Rev. 1.

"* * * a purchase (by a corporation of its own shares) would be proper under any of the following circumstances: (1) if the purchase were made from surplus, and the stock carried no liabilities; (2) if the corporation were solvent, and it had statutory permission to reduce its capital stock, and the court, as a condition precedent to enforcing the contract, required the corporation to avail itself of this statutory permission so that the purchase price should be in fact paid out of a surplus which emerges through the reduction of the capital stock; (3) if the corporation were solvent, and were in liquidation so that the possibility of harm to future creditors might safely be dismissed as negligible." Warren, The Progress of the Law: Corporations, 1921, 34 Harv.L.Rev. 282, 294–295.[4]

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3 See, Borg v. International Silver Co., infra, Crosby v. Stratton, infra.

4 On the purchase by a corporation of its own shares, see: Ballantine, Questions of Policy in Drafting a Modern Corporation Law, 1931, 19 Calif.L.Rev. 465, 479; Berle, Corporate Devices for Diluting Stock Participations, 1931, 31 Col.L.Rev. 1239, 1255; Blackstock, A Corporation's Power to Purchase Its Own Stock and Some Related Problems, 1935, 13 Tex.L.Rev. 442; Dodd, Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law, 1941, 89 U. of Pa.L.Rev. 697; Glenn, Treasury Stock, 1929, 15 Va.L.Rev. 625; Levy, Purchase by an English Company of Its Own Shares, 1930, 79 U. of Pa.L.Rev. 45 (an answer to Glenn); Levy, Purchase by a Corporation of Its Own Stock, 1930, 15 Minn.L.Rev. 1; Hills, Model Corporation Act, 1935, 48 Harv.L.Rev. 1334, 1370–1376; Nussbaum, Acquisition by a Corporation of Its Own Stock, 1935, 35 Col.L.Rev. 971; Pollis, The Purchase by a Corporation of Its Own Shares of Stock—A Suggested Legislative Approach, 1939, 4 U. of Newark L.Rev. 418; Wormser, The Power of a Corporation to Acquire Its Own Stock, 1915, 24 Yale L.J. 177; Warren, Safeguarding the Creditors of Corporations, 1923, 36 Harv.L.Rev. 509, 539–544; Notes, 1933, 3 Brooklyn L.Rev. 110; 1907, 7 Col.L.Rev. 340; 1913, 13 Col.L.Rev. 148; 1925, 10 Corn.L.Q. 371; 1933, 18 Corn. L.Q. 589; 1937, 27 Geo.L.J. 217; 1905, 18 Harv.L.Rev. 531; 1914, 27 Harv.L.Rev. 747; 1928, 41 Harv.L.Rev. 657; 1918, 2 Minn.L.Rev. 456; 1928, 1 So.Calif.L.Rev. 361; 1932, 19 Va.L.Rev. 85; 1928, 26 Mich.L.Rev. 574.

On accounting problems arising from the purchase by a corporation of its own shares, see Katz, Accounting Problems in Corporate Distributions, 1941, 89 U. of Pa. L.Rev. 764, 779–788.

On the income tax question, see Rankin, Income Tax Aspects of a Corporation's Dealings in its Own Shares, 1941, 89 U. of Pa.L.Rev. 934.

RETIREMENT OF REACQUIRED SHARES AS AFFECTING AUTHORIZED CAPITAL[5]

I. Introduction

Modern American corporation law permits a corporation, subject to various safeguards, to purchase its own stock. Such shares are commonly termed treasury shares.[6] They may be paid for either out of surplus, or out of capital.[7] Depending on which account is used, the legal results will vary. Where surplus has been applied, the shares will generally remain in existence; where capital has been resorted to, the transaction will usually involve retirement of the shares. Some jurisdictions, among them New York, require not only a reduction of capital—a money figure corresponding to the balance sheet liability shown for issued shares—but also a simultaneous reduction of the *authorized* capital stock or number of shares. Other states, *e.g.*, Delaware, treat treasury shares as if they were authorized, but unissued.

II. Acquisition by a Corporation of Its Own Shares

Aside from § 28 of the Stock Corporation Law, entitled "Redemption, purchase or retirement of preferred stock out of capital," the New York statutes grant no specific authority for a corporation's reacquisition of its shares. Such power may, however, be implied from the Penal Law,[8] which forbids directors to apply any portion of the corporation's funds, *except surplus,* directly or indirectly, to the purchase of shares of its own stock, except as provided or permitted by law. The courts have permitted corporations to purchase their own shares, provided and so long as, surplus was available for that purpose. As early as 1858, the Court of Appeals held that, in the absence of prohibition by statute, a corporation in full operation with a capital equivalent to its authorized capital stock might purchase its

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[5] Law Revision Commission Act, Recommendation and Study Relating To The Acquisition by a Corporation of its Own Shares, and the Effect of Retirement of such shares, Legislative Document (1947), No. 65(I) (Williams Press, Albany, 1947) 19–26.

This study was made at the direction of the Law Revision Commission by Carlos L. Israels, Esq., of the New York City Bar, Research Consultant, who was assisted by Felix Taubenblatt, Research Assistant.

[6] See California Civil Code (Deering) § 278: "'Treasury shares' means shares issued and thereafter acquired by the corporation, but not retired or restored to the status of unissued shares." There is, however, no agreement on the definition of treasury shares (11 Fletcher, Corporations (Perm. Ed., 1932) § 5088) and it has been pointed out that they may not be accurately described as "unissued shares, issued shares, cancelled shares, outstanding shares, assets, or non-assets" (Note, The Legal Status of Treasury Shares, (1937) 85 Univ. of Penn.L.Rev. 622, 628). In Ballantine and Sterling, California Corporation Laws (1938 ed.) the authors, speaking generally and apparently without limitation to California, define treasury stock as shares which have been issued and thereafter reacquired by the corporation, but not retired.

[7] The trend, at least as regards the acquisition of other than redeemable preferred and special stock, is said to require acquisition out of earned surplus. See Scovill, Treasury Stock in its Relation to Earned Surplus, (1943) 21 Chicago-Kent L.Rev. 328.

[8] § 664, subd. 5.

own stock, hold it unextinguished, and resell it by action of the board of directors; that such purchase operated to diminish the capital stock only if the corporation so intended, and the resale was not invalid because requirements applicable to an original issue were not observed.[9] In Cross v. Beguelin, [10] a corporation's agreement to purchase its own stock was held to have been valid when made, because a surplus then existed, and unenforceable, as against it, when the surplus had shrunk to a deficit. In Norwalk v. Marcus,[11] which dealt with the "sterner legislative policy" in regard to a bank's agreement to repurchase its stock, the Court said:

"In dealing with stock corporations generally, the Legislature has found it necessary, in the interest of the public, to declare invalid agreements by corporations to repurchase shares of their own stock except out of surplus. (Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N.Y. 206; Cross v. Beguelin, 252 id. 262.)"

III. Disposition of Reacquired Shares

Shares reacquired by the corporation from surplus may be resold. Such action is within the discretion of the board of directors[12] and no action by the stockholders is required, unless it is otherwise provided in the certificate of incorporation.[13] Pre-emptive rights do not attach[14] except where there has been a breach of fiduciary duty on the part of the directors in reissuing the shares[15] or where the corporation buys its stock in order to retire it or hold it indefinitely and then proceeds to resell it.[16] Unless the corporation sees fit to "eliminate" the purchased shares,[17] the authorized capital stock will not be reduced. It follows that the resale of these shares involves no increase of authorized shares taxable under the Tax Law.[18]

An entirely different situation prevails in regard to preferred stock redeemable by its terms at the option of the corporation.[19] Under § 28 of the Stock Corporation Law such stock may be either redeemed or purchased out of capital. A resolution of the board of directors is sufficient, unless the stockholders have restricted such authority in the certificate of incorporation or other certificate filed pursuant to law. However, the invasion of capital is subject to two restrictions.

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9 The City Bank of Columbus v. Bruce and Fox, 17 N.Y. 507, 511 (1858).

10 252 N.Y. 262 (1929), affirming 226 App.Div. 349.

11 235 App.Div. 211 (First Dept., 1932) affirmed 261 N.Y. 615.

12 Drinker, The Pre-emptive Right of Shareholders to Subscribe to New Shares (1930) 43 Harv.L.Rev. 586, 603.

13 2 Fletcher, Corporations (Perm. Ed., 1931) § 523. See City Bank of Columbus v. Bruce, supra, note 4.

14 Stock Corporation Law, § 39(4) (c).

15 Hammer v. Werner, 239 App.Div. 38 (Second Dept., 1933).

16 "Where there is no inequitable conduct or where the stock has not in substance been retired, a pre-emptive right may not arise." Hammer v. Werner, supra, note 10, at 44. Note, The Legal Status of Treasury Shares, (1937) 85 Univ. of Penn.L.Rev. 622, 623.

17 In accordance with Stock Corporation Law, § 36 (C).

18 N. Y. Tax Law, § 180.

19 N.Y. Stock Corp. Law, § 28.

First, the amount applied must not exceed the capital represented by the shares redeemed or repurchased. A premium, for instance, is thus excluded and would have to be paid from surplus.

Second, the actual value of the remaining assets must at least equal the total amount of debts and liabilities, plus the amount of capital reduced by the amount of capital applied. If the directors keep within these limits, they are not liable for unlawful dividends or distribution of assets.[20]

May the corporation reissue such stock? Is it treasury stock or must it be retired? The answers to these questions point up the somewhat confusing terminology employed by the statute:

"Whenever any such stock corporation shall have *in its treasury* shares of any class of such preferred stock so redeemed or purchased out of capital. . . . *it may, unless otherwise provided* in its certificate of incorporation or other certificate filed pursuant to law, by resolution of the board of directors, *retire such preferred stock.*" [21]

It follows that preferred stock, redeemed out of capital is "treasury" stock. There is a clear implication that under certain circumstances such shares need not be retired. Despite this, the shares must be eliminated from authorized capital stock, for subdivision 3 of § 28 prescribes that where capital has been applied to the redemption or purchase of preferred shares, the corporation *shall* file a certificate of reduction of capital, which *shall* contain statements to effect both the reduction (a) of capital and (b) of capital stock or the elimination of previously authorized shares, and that upon the filing all shares so redeemed or purchased *shall* be eliminated from the authorized capital stock or number of shares of the corporation and the capital of the corporation *shall* be reduced accordingly.

Since the *authorized* capital stock is decreased upon the purchase or redemption of preferred shares out of capital, any later reissue of such shares requires new authorization, increasing the number of authorized shares, which in turn requires action by the stockholders.[22] Unless it is otherwise provided in the certificate of incorporation, or other certificate filed pursuant to law, or unless the issue of such shares is for one of the special purposes enumerated in subdivision 4 of section 39 of the Stock Corporation Law, preemptive rights would attach, under section 39, to shares issued pursuant to such an increase of authorized shares.

The increase of authorized capital stock is taxable under § 180 of the Tax Law. It is noteworthy that for almost twenty-seven years § 180 contained the following provision:

"And in case of a decrease of capital stock, upon which the tax required by law has been paid, and a subsequent increase thereof, a tax shall be paid only upon so much of such increase as exceeds the amount of capital stock upon which a tax has been before paid."

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[20] Stock Corporation Law, § 58.

[21] Stock Corporation Law, § 28; emphasis supplied.

[22] A certificate increasing the authorized shares pursuant to Stock Corporation Law, § 36 requires the vote of the holders of a majority of the outstanding shares entitled to vote. Stock Corporation Law, § 37(3) (a).

The clause was inserted in the section in 1906,[23] but was eliminated in 1933.[24] The Attorney General has ruled that this section now imposes a tax on all increases of capital stock and that the tax is payable on an increase in the authorized capital stock even though such increase is in the exact amount of a prior reduction thereof.[25] Taxwise, therefore, the situation shapes up as follows: Shares purchased from surplus, be they redeemable preferred stock or any other kind, are not eliminated from those the corporation is authorized to issue; upon their redisposition no tax under § 180 falls due. But shares purchased from capital (limited by Stock Corporation Law, § 28, to redeemable preferred stock) will be eliminated from those the corporation is authorized to issue; and if they are to be reissued the tax under § 180 of the Tax Law must first be paid.[26]

1. REPURCHASE

Since a corporation may enter the market to repurchase its own shares, a pretty question of divided loyalty may be raised.

A corporate management, determining to repurchase some of the corporation's own shares, finds the interests of the corporation in direct conflict with the selling shareholder. The corporate interest is to buy low; the stockholder's interest is to sell high. Where there is a wide public market, and the transaction merely takes place at an appraisal placed on the shares by a great number of outside buyers and sellers, the conflict of interest is minimal: the corporation as buyer, the stockholder as seller, decide to buy and sell at a current market rate.

But where the market is "thin" and the corporation's own operations affected, the temptations may be very great. The sale of a block by the corporation may depress the market; a purchase may raise it. A thoughtful management will wish to consider these factors as well as the mere advantage to the corporation in deciding its course.

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23 Laws of 1906, Chap. 524.

24 Laws of 1933, Chap. 521.

25 (1945) Op.Atty.Gen., February 17. The case concerned an insurance company which reduced its authorized capital stock by reducing the par value of each share. No reacquisition of shares was involved. See Appendix.

26 The extent to which the present rule increases the tax burden of corporations refunding their preferred stocks is difficult to prognosticate. Theoretically, it would be possible under a statute like Tax Law, § 180 as it existed prior to 1933, for a corporation to call a preferred issue, reclassify the shares by changing dividend rates, par value etc., under § 36 of the Stock Corporation Law, and then sell the refunding issue without paying a new organization tax, regardless whether the funds for redeeming the shares are charged against capital or surplus. As a practical matter, however, when a corporation must resort to capital in order to redeem its callable preferred stock, it will probably not have the funds necessary to accomplish the redemption except from the proceeds of the new issue, so that for a period of perhaps thirty days both the new and old issues will be outstanding. In such a situation an organization tax sufficient to authorize the new issue would have to be paid, unless the corporation had in its treasury preferred shares previously retired, which could be reclassified and used, or had already obtained authority to issue additional shares.

If there is no recognized market, and the corporation negotiates separately with a shareholder, the problem becomes greater.

It must be remembered that a corporate management within limits can make the corporate picture seem rosy or bleak. By committing its earnings to very heavy maintenance and depreciation charges, it may conceal to some degree its real prosperity. By limiting its maintenance and depreciation work, and ceasing to carry on expansion, it may increase its apparent earnings and offer hope of larger dividends. It may directly affect the market by adopting a generous or niggardly dividend policy. In consequence, it is in a position materially to affect the price at which it can buy or sell.

Particularly where there is concentrated ownership of stock—one or two individuals holding large blocks—their interests may be adverse to the other holders. A stockholder in a 90% income tax bracket, for instance, will normally prefer that dividends shall be kept low, and earnings "plowed in" to the corporate structure, thereby accomplishing a steady swell up in the value of his stock. On sale of the stock he would then pay merely the capital gains tax of 25% if he had held for the requisite length of time. A small stockholder, needing and wanting current dividends, and a high market value in case he were forced to resell, would wish an exactly opposite policy.

All of these circumstances must be remembered in dealing with the bare legal problem of corporate power to reacquire its own stock; and all of these circumstances bear on the problem. Later, in discussing management, some of these problems reappear in connection with rules of law affecting the participation of the management in the market.

(a) When Permissible

TREVOR v. WHITWORTH.

House of Lords, 1887. 12 A.C. 409.

Appeal from a decision of the Court of Appeal.

James Schofield & Sons Limited were incorporated in 1865 under the Companies Act 1862 with a capital of £150,000 in 15,000 shares of £10 each. The objects, as stated in the memorandum of association, were to acquire and carry on the business of certain flannel manufacturers, and any other businesses and transactions which the company might consider to be in any way conducive or auxiliary thereto, or proper to be carried on in connection therewith.

The memorandum did not authorize the company to purchase its own shares.

Several of the articles of association dealt with the purchase of shares by the company. In the view which the House took it is necessary to refer only to two.

Article 179. "Any share may be purchased by the company from any person willing to sell it, and at such price, not exceeding the then marketable value thereof, as the board think reasonable."

Article 181. "Shares so purchased may at the discretion of the board be sold or disposed of by them or be absolutely extinguished, as they deem most advantageous for the company."

The company having in 1884 gone into liquidation in the Court of Chancery of the County Palatine of Lancaster, a claim was made against the company by the respondents, as executors of Whitworth a deceased shareholder, for the balance of the price of Whitworth's shares sold by the executors to the company in 1880, and not wholly paid for. The circumstances under which the purchase in question and other purchases by the company of its own shares were effected are stated in the judgments.

A summons having been taken out by the appellants, the official liquidators, to determine whether the claim ought to be allowed, the Vice-Chancellor of the county palatine made an order declaring that, without prejudice to any claim by the claimants against any persons other than the liquidators and the company, the claim against the company ought not to be allowed.

The Court of Appeal (Cotton, Bowen and Fry L.JJ.) reversed this decision and allowed the claim. Against this decision the liquidators now appealed. The only question material to this report being the general question, whether such a company can purchase its own shares, the arguments on the other points are omitted.

LORD HERSCHELL. * * *

I pass now to the main question in this case, which is one of great and general importance, whether the company had power to purchase the shares. The result of the judgment in the Court below is certainly somewhat startling. The creditors of the company which is being wound up, who have a right to look to the paid-up capital as the fund out of which their debts are to be discharged, find coming into competition with them persons who, in respect only of their having been, and having ceased to be, shareholders in the company, claim that the company shall pay to them a part of that capital. The memorandum of association, it is admitted, does not authorize the purchase by the company of its own shares. It states, as the objects for which the company is established, the acquiring certain manufacturing businesses and the undertaking and carrying on the businesses so acquired, and any other business and transaction which the company consider to be in any way auxiliary thereto, or proper to be carried on in connection therewith. * * *

Let me now invite your Lordships' attention to the facts of the present case. The company had purchased, prior to the date of the liquidation, no less than 4142 of its own shares; that is to say, considerably more than a fourth of the paid-up capital of the company had been either paid, or contracted to be paid, to shareholders, in consideration only of their ceasing to be so. I am quite unable to see how this expenditure was incurred in respect of or as incidental to any of the objects specified in the memorandum. * * *

What was the reason which induced the company in the present case to purchase its shares? If it was that they might sell them again, this would be a trafficking in the shares, and clearly unauthorized. If

it was to retain them, this would be to my mind an indirect method of reducing the capital of the company. The only suggestion of another motive (and it seems to me to be a suggestion unsupported by proof) is that this was intended to be a family company, and that the directors wanted to keep the shares as much as possible in the hands of those who were partners, or who were interested in the old firm, or of those persons whom the directors thought they would like to be amongst this small number of shareholders. I cannot think that the employment of the company's money in the purchase of shares for any such purpose was legitimate. The business of the company was that of manufacturers of flannel. In what sense was the expenditure of the company's money in this way incidental to the carrying on of such a business, or how could it secure the end of enabling the business to be more profitably or satisfactorily carried on? I can quite understand that the directors of a company may sometimes desire that the shareholders should not be numerous, and that they should be persons likely to leave them with a free hand to carry on their operations. But I think it would be most dangerous to countenance the view that, for reasons such as these, they could legitimately expend the moneys of the company to any extent they please in the purchase of its shares. No doubt if certain shareholders are disposed to hamper the proceedings of the company, and are willing to sell their shares, they may be bought out; but this must be done by persons, existing shareholders or others, who can be induced to purchase the shares, and not out of the funds of the company. * * *

I move your Lordships that the judgment appealed from be reversed, and the judgment of the Vice-Chancellor restored, and that the respondents do pay to the appellants the costs in the Court of Appeal and in this House, and do repay to the appellants any moneys and costs received from them. * * *

CRANDALL v. LINCOLN.

Supreme Court of Errors of Connecticut, 1884. 52 Conn. 73, 52 Am.Rep. 560.

Bill in Equity brought by the plaintiffs as receivers of the Willimantic Trust Company, a corporation, against a large number of former stockholders of the company who had sold their shares of stock to the company and been paid for the same from its capital. * * *

CARPENTER, J. The Willimantic Trust Company, a corporation, by special charter, being insolvent, went into the hands of receivers in April, 1878. The assets of the company are not sufficient to pay its liabilities, the deficit being about $35,000. Prior to its failure the affairs of the company were managed by a board of fifteen trustees. The by-laws required the trustees to appoint from their number an executive committee of five. The duties of the executive committee, so far as material, are found in the fifth section of the by-laws, as follows:—"The executive committee shall superintend and direct with reference to all the business transactions of the company, especially as to the investment and disposal of its funds in stocks, bonds, mortgages and other

securities, and all guardianships, receiverships and other special trusts, none of which shall in any case be accepted without their approbation, except such as shall be made by an order of a court of competent jurisdiction."

On the first of January, 1875, there was no surplus. On the first day of May following its stock was impaired, its actual value being then about seventy-five per cent. of its par value. The officers and managers of the institution expected to realize enough from its assets to make the stock worth par, and believed that it was worth par. Some little time before the 14th day of June, 1875, as the company had in uninvested cash about $10,000, the scheme of purchasing the shares of the company by the corporation was talked over by the officers of the company. Nothing was determined upon in relation thereto, although the idea was favorably received, until the meeting of the executive committee on the 14th day of June, 1875, at which time the matter was fully talked over by the officers and the whole executive committee, and it was then determined to purchase stock of the corporation, and the president and secretary were instructed to proceed to purchase the same to the amount of $10,000. There was no vote or resolution of the executive committee to that effect, and no record thereof was kept. The purchases of stock made from time to time were reported to the trustees, and to the stockholders at their annual meeting in the spring of each year, and the executive committee and board of trustees were kept advised from time to time as the purchases were made. More than the $10,000 was so spent, and it is found that there was a general understanding existing at all times on the part of the executive committee that such purchases were being made, and the president and secretary always supposed that they had full authority to make such purchases; and when these transactions were reported to the executive committee, the board of trustees, and the stockholders, such action on the part of the president and secretary was approved. In that way three hundred and twenty-six shares of stock of the trust company were sold and transferred to the company, for which was paid out to stockholders more than $30,000 of its funds. To enable the receivers to pay the debts they have brought this suit to recover of these stockholders the amount so received by them.

The first question presented for our consideration is, whether the purchase of stock by the corporation in the manner stated and under the circumstances was legal.

The stock of a corporation is its only basis of credit. Unlike a partnership, its members generally are not individually liable for its debts.[27] The character, reputation and credit of its promoters do not attach to the corporation itself except to a limited extent. Hence it is of vital importance that the law should rigidly guard and protect the capital stock. Otherwise, especially in these days when so large a portion of the business of the country is carried on by corporations, confidence, on which the prosperity of the country largely depends, would be seriously impaired. Hence it is that in equity the capital stock of a corpo-

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[27] Cf. N.Y.Stock Corporation Law, §§ 70–73.

ration is now regarded as a trust fund for the payment of debts.[28] The creditors have a lien upon it, which is prior in point of right to any claim which the stockholders as such can have upon it; and courts will be astute to detect and defeat any scheme or devise which is calculated to withdraw this fund, or in any way to place it beyond the reach of creditors. A leading case on this subject is Wood v. Dummer, Fed.Cas. No. 17,944, 3 Mason, 308. Story, J., says: "It appears to me very clear upon general principles, as well as the legislative intention, that the capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank. The public, as well as the legislature, have always supposed this to be a fund appropriated to such purpose. The individual stockholders are not liable for the debts of the bank in their private capacities. The charter relieves them from personal responsibility and substitutes the capital stock in its stead. Credit is universally given to this fund by the public, as the only means of payment. During the existence of the corporation it is the sole property of the corporation, and can be applied only according to its charter, that is, as a fund for payment of its debts, upon the security of which it may discount and circulate notes. Why otherwise is any capital stock required by our charters? If the stock may, the next day after it is paid in, be withdrawn by the stockholders without payment of the debts of the corporation, why is its amount so studiously provided for, and its payment by the stockholders so diligently required? To me this point appears so plain upon principles of law, as well as of common sense, that I cannot be brought into any doubt that the charters of our banks make the capital stock a trust fund for the payment of all the debts of the corporation. * * *

These views are abundantly sustained by the authorities from which we have quoted and from many more which might be cited. We do not intend to say that under no circumstances can a corporation legally become the owner of its own stock. Should it loan money to a stockholder and be obliged to take its own stock in payment, that would not be illegal per se. So too it may be allowable for a company to purchase temporarily with its surplus earnings; but stock should not be held indefinitely; it should be disposed of in a reasonable time. If not, and should creditors thereby be prejudiced, perhaps the managers of the company might be liable.

Nor do we intend to say that a direct purchase would be declared illegal at the instance of a party to the transaction. If the stock is reissued and creditors are not prejudiced probably the courts would not interfere. But as a rule to which there are few if any exceptions, when a stockholder conveys his stock to the company and receives in return a portion of the capital, he holds the money so received subject to the superior equities of creditors.[29]

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28 See, supra, pp. 270 et seq., on the trust fund theory.

29 Stockholders who knew they were selling to the corporation were held liable. Certain stockholders had sold their shares in good faith to an undisclosed agent of the company. They were held liable on the ground that: "* * * Under no circumstances can a stockholder sell his stock to the company and take therefor his portion of the capital stock to the prejudice of creditors. The illegality of the transaction does not at all depend upon the actual knowledge or mala fides of the

Our conclusion is that the capital stock of the company being impaired when the stock in this case was purchased, and the stock in each case having been paid for from the capital, the transactions were illegal and cannot be sustained. * * *

Judgment for plaintiff.

In re FECHHEIMER FISHEL CO.

Circuit Court of Appeals of the United States, Second Circuit, 1914. 212 F. 357.

Appeal from the District Court of the United States for the Southern District of New York.

In the matter of Fechheimer Fishel Co., bankrupt. From an order confirming an order of the referee postponing payment of any dividend upon the claim of the estate of Bernard Rothenberg, deceased, until after the claims of general creditors had been paid in full, Albert Dellevie, as sole surviving executor appeals.

The Fechheimer Fishel Company is a corporation organized under the laws of the state of New York and doing business in the city of New York. Its capital stock was fixed at $550,000, divided into 5,500 shares of the par value of $100 per share, and of this amount all but $20,000 was issued. In addition debenture bonds aggregating $550,000 were authorized, all of which were issued except $20,000 retained in the treasury of the corporation for future use. The bonds and stocks were issued to the organizers of the corporation, each of whom held, dollar for dollar, equal amounts of bonds and of stock.

By agreement, made part of the bonds, it was provided that "bonds" and stock should be inseparable and that on any sale of "bonds" an equal amount of stock should go with them. The right to sell or dispose of the bonds and stock held by any member of the corporation was limited to a sale to the other members in the manner provided by the agreement, and it was required that on the retirement of any member, for any reason, his bonds and stock should be sold to the other members at the book value of the bonds or else that the corporation should be dissolved and liquidated.

On November 1, 1909, Bernard Rothenberg was the holder of a "bond" of the Fechheimer Fishel Company for $50,000 and a like amount of its stock and was also treasurer of the company. On that date he indorsed in blank and delivered to the company the "bond" and the certificate for the stock and received from the company a note for $50,000, dated November 1, 1909, payable two years after date, with interest at 6 per cent. per annum, payable semiannually. He also received an agreement by the company to pay him an additional 2 per cent. per annum so as to make the interest on the note equal to the interest on the bond. This agreement was not actually dated or delivered until January, 1910, but was apparently part of the same transaction in which the note was given. This note was entered by

seller; if he in fact sells to the company and receives in return a part of the capital, the policy of the law requires him to know it, and conclusively charges him with knowledge. Thus selling, he sells at his peril. In no other way can the rights of creditors be protected." 52 Conn. 73, 104.

Rothenberg himself in the company's bills payable book, but on the last page, and not where such an entry would naturally appear. The bond and stock was put, in an envelope marked with Rothenberg's name, in the company's safe. The bond was never canceled in the manner customary when bonds were surrendered. On August 9, 1911, this note was renewed by a new note for the same amount, payable November 1, 1912, accompanied by a similar agreement for the payment of additional interest. This is the note on which the claim is made. The Fechheimer Fishel Company was adjudicated bankrupt.

It was contended by the trustees in bankruptcy and held by the referee and by the court below:

First, that the so-called "bonds" were in reality merely a form of preferred stock and as such subject to the general rules of law applicable to a corporation's purchase of its own stock.

Second, that the corporation had no right to buy its own stock unless it was possessed of net profits sufficient to pay therefor without diminishing the fund upon which creditors had a right to rely.

Third, that the claimant was bound by the terms of the "bond" or stock and could not receive any payment in advance of general creditors.

ROGERS, Circuit Judge (after stating the facts as above). * * * The bond for $50,000 which Rothenberg surrendered to the company on November 1, 1909, being in effect preferred stock of the company, the transaction was therefore a purchase by the company of its own stock and payment therefor by the issue of its own note, which, after renewal, matured when the company was insolvent. We are thus led to inquire whether the company had the right to purchase the stock and, if so, under what conditions.

The courts are not at all agreed concerning the right of a corporation to purchase its own stock.

The view that a corporation cannot buy its own stock without an express grant is based on the following grounds:

1. That corporations cannot increase or diminish their capital stock without the sanction of the Legislature.

2. That such a transaction is a fraud upon creditors.

3. That it is foreign to the purposes for which the corporation was created.

In England the courts, in a long and unbroken line of decisions, have held that a corporation, unless expressly authorized to do so, cannot purchase its own stock. The leading case in that country upon the subject was decided in the House of Lords in 1887, Trevor v. Whitworth, L.R. 12 App.Cas. 409.

In the United States the courts of some of the states have followed the English rule. But the clear weight of authority upholds the right of a corporation to buy its own stock if the purchase is made in good faith and does not prejudice the rights of creditors. Cook on Corporations, vol. 1, 7th Ed., § 311.

The text-writers have arrayed themselves generally on the side of the English rule. Thompson on Corporations says, in volume 2, § 2054:

"The rule which forbids a corporation thus to employ its funds rises to the grade of a rule of public policy; and is so strong that although power is conferred upon the company to deal in the shares of joint-stock companies generally, this does not authorize it to deal in its own shares."

Machen on Modern Law of Corporations says, in volume 1, § 628:

"In America, many courts uphold the same sound and wholesome doctrine as the English cases. But it must be conceded that a somewhat larger number of the American courts have taken the view that a corporation may without express statutory authority purchase its own shares, provided the purchase is entered into bona fide and does not endanger the claims of creditors. It should be observed that the American cases which agree with the English doctrine are often well considered and fully reasoned, whereas those which uphold the contrary view generally lack any extended examination of the subject."

Mr. Morawetz, in his work, says in volume 1, § 112:

"No verbiage can disguise the fact that a purchase by a corporation of shares in itself really amounts to a reduction of the company's assets, and that the shares purchased do in fact remain extinguished, at least until the reissue has taken place. The fact that such a transaction may not necessarily be injurious to any person is not a sufficient reason for supporting it. It is contrary to the fundamental agreement of the shareholders, and is condemned by the plainest dictates of sound policy. To allow the directors to exercise such a power would be a frightful source of unfairness, mismanagement, and corruption. It is for these reasons that a shareholder cannot be allowed to withdraw from a corporation with his proportionate amount of capital, either by a release and cancellation before the shares have been paid up, or by a purchase of the shares with the company funds."

We have referred to the opinions of these writers because we think that, in recognizing the right of a corporation to buy its own stock, they indicate the necessity of confining the right to purchase within strict limits. Indeed, the dangers incident to the recognition of the right has led the Legislatures in a number of the states to prohibit the right altogether. And Congress in enacting the law relating to national banks has denied to such banks any right to purchase their own stock.

The corporation which purchased its stock in the case at bar was organized under the laws of New York, was engaged in business in New York, and entered into the purchase of the stock in New York. And under the law of New York a corporation has the right to purchase its own stock. City Bank of Columbus v. Bruce, 17 N.Y. 507, 1858; Vail v. Hamilton, 85 N.Y. 453, 457, 1881; Joseph v. Raff, 82 App.Div. 47, 54, 81 N.Y.S. 546, affirmed 176 N.Y. 611, 68 N.E. 1118. But the purchase must be made out of surplus profits and cannot be made from the capital. The Penal Law of the state provides, in section 664, that:

"A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended: * * * (5) To apply any portion of the funds of such cor-

poration, except surplus profits, directly or indirectly, to the purchase of shares of its own stock—is guilty of a misdemeanor." * * * [30]

The note for $50,000 due November 1, 1912, which is the basis of the claim involved in this case is a renewal of a note for the same amount given by the bankrupt on November 1, 1909. Whatever infirmity inhered in the original note attached to the renewal note. Hamor v. Taylor-Rice Engineering Co., C.C., 84 F. 392, 398, 1897. As the note was given by the corporation for its own stock, the right to enforce payment out of the assets of the corporation depends upon the existence of surplus profits.

If at the time the stockholder receives payment for his stock the payment prejudices the creditors, payment cannot be enforced. If a stockholder sells his stock to a corporation which issued it, he sells at his peril and assumes the risk of the consummation of the transaction without encroachment upon the funds which belong to the corporation in trust for the payment of its creditors.

The right of the creditors of the corporation cannot be defeated by the fact that at the time the transaction was entered into the seller of the stock and the officers of the company who purchased it were acting in good faith and supposed that the company was solvent. * * *

The stock of a corporation is its only basis of credit, and it is of vital importance that it be rigidly guarded and protected. Courts have conceived it to be their duty to detect and defeat any scheme or device calculated in any way to place this fund beyond the reach of the creditors. Buck, Trustee, v. Ross, 68 Conn. 29, 31, 35 A. 763, 57 Am.St.Rep. 60, 1896. As the illegality of a purchase by a corporation of its stock rests upon the fact that it withdraws assets upon which the creditors have a superior right or lien, it seems to us that even though the company may have been solvent when the contract to purchase was made, if it becomes insolvent later or is made insolvent by the transaction and is in that condition at the time when payment is to be made, the vendor cannot as against creditors be permitted to

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[30] See Note, 1937, 12 St.John's L.Rev. 115.

Cf., N.Y.Stock Corporation Law, § 58, supra, p. 384, but see N.Y.Stock Corporation Law, § 28, which now permits a corporation to repurchase its preferred stock out of capital to a limited extent.

Cf. Ill.Business Corporation Act, § 6, Smith-Hurd Stats. c. 32, § 157.6: "*Power of corporation to acquire its own shares.* A corporation shall have power to purchase, take, receive, or otherwise acquire * * * its own shares, provided that it shall not purchase, either directly or indirectly, its own shares when its net assets are less than the sum of its stated capital, its paid-in surplus, any surplus arising from unrealized appreciation in value or revaluation of its assets and any surplus arising from surrender to the corporation of any of its shares, or when by so doing its net assets would be reduced below such sum. Notwithstanding the foregoing limitations, a corporation may purchase its own shares for the purpose of: (a) Eliminating fractional shares. (b) Collecting or compromising claims of the corporation, or securing any indebtedness to the corporation previously incurred. (c) Paying dissenting shareholders entitled to payment for their shares in the event of a merger or consolidation or a sale or exchange of assets. (d) Effecting, subject to the other provisions of this act, the retirement of its redeemable shares by redemption or by purchase at not to exceed the redemption price."

See, Ballantine, A Critical Survey of the Illinois Business Corporation Act, 1934, 1 U. of Chi.L.Rev. 357, 364; Little, The Illinois Business Corporation Law, 1934, 28 Ill.L.Rev. 997, 1006–1011.

take the assets for that purpose in a state in which the statutes make it a criminal offense to apply directly or indirectly anything but surplus profits to the purchase by a corporation of its own stock. If the stockholder postpones the time of payment, he runs the risk of the corporation becoming insolvent in the meantime and must be held to a knowledge of the fact that he cannot enforce payment if in doing so he deprives the creditors of assets upon which they have a lien superior to any claim of his. In the case at bar, when the corporation bought the stock and gave its note to Rothenberg, it in effect promised to pay him $50,000 out of surplus profits and if payment could be made without prejudice to creditors. To be sure the note did not so state on its face, but that was a condition which the law attached to it and which was binding on both Rothenberg and the company. The fact that the corporation had a surplus when the note was given is not decisive of the case if it was insolvent when the time for payment arrived. What the rule may be in the absence of such a statutory provision as exists in New York we need not now determine. * * *

The order of the court below is affirmed.[31]

WOLFF v. HEIDRITTER LUMBER COMPANY.

Court of Chancery of New Jersey, 1932. 112 N.J.Eq. 34, 163 A. 140.

Suit by H. Edward Wolff and others against the Heidritter Lumber Company, in which a receiver was appointed for the defendant corporation and Adolph U. Poppenga filed proof of claim as a creditor. From a disallowance of the claim, the claimant appeals.

Appeal sustained, and claim allowed as that of a general creditor.

BUCHANAN, VICE CHANCELLOR. The bill in this case was filed for the appointment of a receiver and the winding up of the defendant corporation, under the statute. * * *

Poppenga's claim is based upon a written agreement, dated July 9, 1924, between himself and the defendant lumber company, whereby he agreed to sell and the lumber company agreed to buy from him 150 shares of the capital stock of the lumber company for $40,000.

The agreement provides that Poppenga "hereby sells" and the lumber company "hereby purchases" the said stock, and that the purchase price is to be paid by the lumber campany in installments of $1,000 each, every three months, commencing October 9, 1924, together with interest on the balance unpaid from time to time; that upon final payment in full Poppenga will transfer the shares to the lumber company; that Poppenga shall have right to repurchase the said shares "at any time during the continuance of this agreement" by repaying to the lumber company the moneys theretofore paid by it.

Prior to the appointment of the receiver in this suit, the lumber company had paid $13,500, with interest, on account of the $40,000

31 Cert. denied, 234 U.S. 760, 34 S.Ct. 777, 58 L.Ed. 1580, 1913.
Notes, 1914, 27 Harv.L.Rev. 747; 1914, 2 Va.L.Rev. 72; 1914, 14 Col.L.Rev. 451. See, also, Note, 1920, 9 A.L.R. 1296.

purchase price. Poppenga's claim is for the balance, $26,500, together with interest from January 15, 1931.

The receivers concluded that, by reason of the determination in Hoover Steel Ball Co. v. Schaefer Ball Bearings Co., 90 N.J.Eq. 164, 106 A. 471, and the cases therein cited, the claim must be deemed invalid and unenforceable. The facts in the present case are different in several particulars from those in the Hoover Case, and it is contended by claimant appellant that these differences are of such materiality as to relieve the present claim from the interdiction of that decision. It is concluded that this contention is well founded, that the claim is valid, and the appeal must be sustained. * * *

In the instant case the company admittedly had far more than sufficient assets to pay its creditors in full, and all of the stockholders expressly consented to the purchase. Under such circumstances it may well be doubted that much, if any, consideration need be given toward the determination of what is a "legitimate corporate purpose." Aside from the rights of creditors, which in the instant case were in no wise prejudiced or infringed, and the right of the state that no criminal or fraudulent act be perpetrated, which is in no wise intimated in the present case, it would seem that the stockholders are the only ones interested, and that any purchase might be made to which all stockholders expressly assented. If, however, the "legitimate corporate purpose" be deemed a requisite even under such circumstances, no doubt is entertained as to its existence in the case at the bar.

The corporation was involved in litigation wherein persons having a "life estate" in the "inchoate" dividends of certain shares of stock of the company, held by trustees, in trust to pay the "income" on that stock, during the life of a third party, to the litigating complainants and to transfer the stock at the death of the third party to other beneficiaries of whom Poppenga was one, sought to obtain payment of dividends to themselves out of accumulated profits of the company.

An opinion had been filed in the litigation, foreshadowing the possibility, if not the probability, of a decree that the corporation should pay such dividends out of the accumulated profits. The accumulated profits had been put back into the business, so that it would have been very difficult, if not impossible, for the corporation to have paid such dividends at that time without liquidating its affairs, notwithstanding it was amply solvent, as has been said.

The interest or share in the corporate assets represented by these shares of stock held in trust belonged partly to the "dividend" beneficiaries and partly to Poppenga and the other "stock" beneficiaries. If the corporation paid the dividends to the former, the value of the shares of stock to which Poppenga and his associates were entitled would be pro tanto diminished, whereas if Poppenga and his associates advanced to the corporation the money to pay the dividends, the amount of their individual assets, aside from the stock, would be thereby decreased, but this would be compensated for because the value of the shares of stock would not be diminished; the net result to Poppenga and his associates would be substantially the same under either plan,—except that for the corporation to pay the dividends out of the

corporate assets would have entailed such a sacrifice of corporate assets as to result in still geater diminution of the value of the "stockholders" stock, and they all felt it would be much better for themselves and the other stockholders of the company, who also naturally felt the same way about it, if they should advance the dividend money to the company.

Unfortunately Poppenga was unable or unwilling to advance his share out of his other individual assets, and therefore, in order to enable him to get the money to make the necessary advance, this sale of 150 of his shares of stock to the company was agreed on, being at a price higher than he could get elsewhere, yet lower than the book value; and in order to accommodate the company's situation, the payment of the purchase price was made deferred and payable in installments. The immediate cash necessary to make the payment to the "dividend beneficiaries" was obtained from a bank, on Poppenga's note with collateral, including the stock and the company's agreement to pay Poppenga the $40,000.

The purchase by the company was therefore part of an entire transaction intended, and believed to be, and agreed upon by all stockholders as being, and which apparently in fact actually was, for the benefit not only of Poppenga, but also of all the other stockholders of the company. (It does not appear that the present unfortunate financial situation of the company was in any wise attributable to this transaction, or that it could have been forseen at that time.) The corporation is simply the stockholders in corporate form; the interests of the stockholders are the interests of the corporation; the purpose of the corporation is to benefit the interests of the stockholders. The legitimate benefit of the stockholders is therefore a legitimate corporate purpose, especially when all agree.

It is not intended by anything that has been said herein to intimate that a purchase by a corporation of shares of its own stock would be valid if the then present ability of the corporation to pay its creditors in full was in any wise open to doubt, if, for instance, although then honestly believed to be fully solvent, it should later appear doubtful that the company had in fact been then fully solvent. That situation does not exist here, and no opinion is expressed thereon. * * *

The appeal will be sustained, and the claim allowed as that of a general creditor; but, under all the circumstances, costs of the appeal will be awarded against him.

TOPKEN, LORING & SCHWARTZ, Inc., v. SCHWARTZ.

Court of Appeals of New York 1928. 249 N.Y. 206, 163 N.E. 735, 66 A.L.R. 1179.

[Appeal by permission, from an order of the Appellate Division of the Supreme Court in the first judicial department, which reversed a judgment in favor of defendant entered upon an order of Special Term granting a motion for a dismissal of the complaint, and denied the motion.

Plaintiff brought an action on a contract to repurchase its stock. The contract was entered into in 1922 between the Loring Glove Co.,

Inc. (plaintiff) and Julius Schwartz (defendant). Plaintiff agreed to sell 114 shares of its stock to defendant for $11,400, with an option to purchase more under certain conditions. Defendant was employed by plaintiff, and he agreed to resell to the corporation all of its capital stock that he held at the end of his period of employment, at its book value. Defendant's employment terminated June 1, 1927; he refused to resell the 152 shares of stock held by him. Plaintiff seeks a decree ordering that it be declared owner of the stock, and defendant be compelled to transfer the shares. Plaintiff alleged that the stock has neither actual book nor market value, and that it is a closed corporation having only four stockholders. Defendant appeals from a denial of its motion to dismiss the complaint.]

The following questions were certified: "1. Does the complaint herein state facts sufficient to constitute a cause of action for the relief demanded therein? 2. Has the plaintiff herein an adequate remedy at law?"

CRANE, J. (after stating the above facts). * * * Does this complaint state a good cause of action? Is the agreement alleged matter for specific performance?

Section 664 of the Penal Law (Consol.Laws, c. 40) enacts:

"A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended: * * *

"(5) To apply any portion of the funds of such corporation, except surplus profits directly or indirectly, to the purchase of shares of its own stock, is guilty of a misdemeanor."

No corporation, therefore, can buy its own shares of stock out of its capital without making the officers voting such purchase violators of this law.

This provision of the Penal Law of course has application only to the state of New York, but it has generally been held that no corporation can purchase its stock with its capital to the injury of its creditors. The capital of a corporation is held in trust for its creditors, so that any agreement to purchase stock from a stockholder, which may result in the impairment of capital, will not be enforced, or will be considered illegal if the rights of creditors are affected. [Citing cases.] * * *

This contract, therefore, in question, would have been impossible of performance under certain conditions. The defendant Schwartz it is said was bound to sell and convey his stock at book value at the end of his employment. How about the corporation? What were its obligations? If it had no surplus, it could not legally perform the purported contract; it could not make the purchase. Under our statute it would have been illegal; without our statute it would have been unenforceable as against the corporation, if there were creditors and no surplus. Hoover Steel Ball Co. v. Schaefer Ball Bearing Co., supra. Whichever way we look at it, there were certain conditions under which the corporation would be unable to perform its promise to purchase the stock and under which the courts would declare its contract

so to do illegal. If, therefore, we consider the contract in question, as we must, one dependent upon mutual promises for the consideration, we have the defendant promising that at a certain time he will sell at a certain price and the plaintiff promising to buy. The promise is binding upon the defendant but may or may not be binding upon the plaintiff. It is as if the plaintiff had a choice to buy or not as it pleased. By "binding," I mean that the corporation could execute the contract by purchasing the stock out of its surplus, but could not, without violating the law, purchase its stock when it had no surplus. Under these circumstances we have a contract not mutually binding, and therefore lacking in consideration. Schlegel Mfg. Co. v. Cooper's Glue Factory, 231 N.Y. 459, 462, 132 N.E. 148, 24 A.L.R. 1348. "The principle is ordinarily stated in the axiom that in a bilateral agreement both promises must be binding or neither is binding." Williston on Contracts, § 103e. Richards v. Ernst Wiener Co., 207 N.Y. 59, 100 N.E. 592, contains some statements in the opinion which would be very apt to lead one to take the other view and to hold that this contract was good unless it appeared that the corporation were insolvent. The statements to this effect in the opinion are not necessary for the decision of the case as the court considered the contract an option to purchase and a contract of employment. See Matter of Tichenor-Grand Co., D.C., 203 F. 720. If in the case before us the defendant had been given employment and the employment had furnished the price or the consideration for his agreement to return the stock at the end of his employment, we would then have a contract resting not on a mutuality of promises, but upon a consideration given and paid in part by the corporation. Hoover Steel Ball Co. v. Schaefer Ball Bearing Co., supra (last paragraph, page 171 of 90 N.J.Eq., 106 A. 474); volume 1, Williston on Contracts, § 13; Strait v. Northwestern Steel & Iron Works, 148 Wis. 254, 134 N.W. 387. The contract then would be good unless it appeared that the stock would be purchased out of capital. This would be a matter of defense. The situation here, however, is as above stated; the contract for its consideration rests upon mutual promises. One of the promises may or may not be good, the same as if a discretion were left to one of the parties to perform or not perform. Under such circumstances there is no consideration, and the contract cannot be enforced. Specific performance under such circumstances will not be decreed.

For these reasons the order of the Appellate Division should be reversed and that of the Special Term affirmed, with costs in this court and in the Appellate Division. The first question certified should be answered "No," the second question certified not answered.

Ordered accordingly.[32]

[32] Glenn, Treasury Stock, 1929, 15 Va.L.Rev. 625; Notes, 1929, 3 Brooklyn L.Rev. 110, 115; 1929, 15 Corn.L.Q. 108; 1929, 29 Col.L.Rev. 356; 1929, 42 Harv.L.Rev. 829.

See, also, Notes, Illusory Aspect of Corporate Contract to Repurchase Stock, 1937, 12 St.John's L.Rev. 115; Corporation Stock Repurchase Agreements, Mutuality of Obligation and Illusory Promises, 1941, 15 St.John's L.Rev. 253.

GREATER NEW YORK CARPET HOUSE, Inc., v. HERSCHMANN.

Supreme Court of New York, Appellate Division, First Department, 1940.
258 App.Div. 649, 17 N.Y.S.2d 483.

[Appeal by the defendant from an order of the Supreme Court.]

CALLAHAN, JUSTICE. The complaint alleges, in substance, that the plaintiff is a domestic corporation; that defendant is executrix of the estate of Emil M. Herschmann, deceased; that on September 30, 1932, an agreement was made between defendant's testator, one Milton Goldstein and the plaintiff, a copy of which agreement is attached to the complaint. Said agreement provides that on the death of either of said individuals (who were the sole stockholders of the corporation), the corporation would purchase and the stockholder or his personal representatives would sell his respective holdings (250 shares) of the corporate stock for the sum of $25,000.

The complaint further alleges that two policies of life insurance in the sums of $25,000 each had been procured upon the lives of the respective stockholders, payable to the corporation. On the death of either insured, the proceeds of the policy issued on the stockholder's life were to be placed in a special surplus account with which to purchase his stock. Both stockholders agreed that they would not sell their stock to any person until they first offered same to the corporation.

There were additional provisions in the contract whereby the stockholders agreed to make wills directing their executors to sell their stock, and providing that the wives of the stockholders were to bind themselves to convey any interest which they might receive in the stock of their husbands. The agreement, however, was not signed by the wives of the stockholders. The contract bore the seals of the individual signatories.

The complaint alleges the death of Emil Herschmann; that plaintiff had received the $25,000 payable under the policy issued on his life and had placed same in a special surplus account; that defendant has in her possession the stock of her testator; that plaintiff tendered the $25,000 to the defendant and demanded delivery of the stock, but the defendant refused to comply with the terms of the agreement. Plaintiff seeks specific performance of the agreement.

Defendant contends that the complaint is insufficient in that the contract was unenforceable, owing to lack of consideration. Her theory is that the contract is one which might require the plaintiff to purchase its own stock out of capital rather than out of surplus. She contends that the sole consideration for the contract in suit was the mutual promises of the corporation to buy and of defendant's testator to sell the stock involved; that the promise to purchase was not binding upon plaintiff corporation for the reason that it could not legally perform the contract if it had no surplus, and that, therefore, there were no adequate considerations for the agreement.

Plaintiff, on the other hand, contends that there was sufficient legal consideration for the contract, and that the remedy of defendant, if

she claims that it would be illegal at present for the corporation to pay for the stock because of lack of surplus, would be to plead such facts as a defense to this action.

We think that there was a sufficient legal consideration to support the contract. The present agreement was much more than a simple contract for the purchase and sale of stock. It was an attempt by two stockholders who owned all the stock of a corporation to arrange a method whereby the surviving stockholder would acquire complete corporate control. The provision that the corporation would purchase the survivor's stock was merely the means to an end. The agreement, in order to create a fund with which to pay for the stock, provided that the company take out life insurance policies on the lives of both stockholders, payable to the corporation; that the proceeds of these policies were to be set apart as a special surplus account to furnish the purchase price of the stock. While not expressly recited in the contract, we think that it is necessarily to be inferred from its terms that the corporation bargained to pay the premuims for the said insurance, and the facts recited in the complaint indicate that the corporation did in fact pay said premiums between the date of the agreement in 1932 and the death of defendant's testator several years thereafter. This constituted a detriment to the corporation.

For the reasons stated, any claim that despite the arrangement whereby a special surplus account was created to pay for the stock, because of the existence of other debts, there was no corporate surplus sufficient to pay the full purchase price of the stock, would, in our opinion, constitute a defense to the present action.

Defendant relies on the decision in Topken, Loring & Schwartz, Inc., v. Schwartz, 249 N.Y. 206, 163 N.E. 735, 66 A.L.R. 1179, to support her claim that the complaint was insufficient because the contract lacked legal consideration.

We find that the contract now before us is distinguishable from that considered in Topken, Loring & Schwartz, Inc., v. Schwartz, supra, for the reason that here, as noted, there was consideration other than the mutual promises to buy and sell the stock. In the Topken case, supra, it was stated, 249 N.Y. at page 211, 163 N.E. at page 736, 66 A.L.R. 1179: "If in the case before us the defendant had been given employment and the employment had furnished the price or the consideration for his agreement to return the stock at the end of his employment, we would then have a contract resting not on a mutuality of promises, but upon a consideration given and paid in part by the corporation. Hoover Steel Ball Co. v. Schaefer Ball Bearing Co., supra (last paragraph, page 171, of 90 N.J.Eq. 164, 106 A. 474); vol. 1, Williston on Contracts, sec. 13; Strait v. Northwestern Steel & Iron Works, 148 Wis. 254, 134 N.W. 387. The contract then would be good unless it appeared that the stock would be purchased out of capital. This would be a matter of defense."

In the present transaction we find a consideration given and paid in part by the corporation, to wit: The maintenance of the insurance policies. In addition, we have the other mutual promises heretofore recited. As these matters express actual consideration, we need not determine whether consideration would be presumed from the fact

that the contract bore the seals of the signatories other than the plaintiff.

It has been stated that the principle enunciated in the Topken case, supra, rested on the reasoning that the corporation's promise was illusory because the existence of a surplus was within the corporation's control. See 1 Williston on Contracts, Rev.Ed., § 133. No such control would exist when, as in the present case, the corporation was required to hold in a special surplus account the money supplied for the purchase of the stock. Therefore, the present case is not one where the plaintiff had a choice to buy or not, as it pleased.

Under the Law of New York, a corporation has the right to purchase its own stock, but the purchase must be made out of surplus, and can not be made out of capital. The provisions of our Penal Law (Section 664) are that "A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended: * * * 5. To apply any portion of the funds of such corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock, * * * is guilty of a misdemeanor." It is plain that no violation of this section could have been contemplated here for no illegal intention, as defined in the statute, could have been present when an arrangement was made whereby a special fund was being created with which the stock was to be purchased. The rights of general creditors of the corporation could not have been prejudiced by making this agreement, for this would be no impairment of capital because of said agreement. Even assuming that at the time of the performance of the contract, because the rights of general creditors might have become impaired meanwhile, the contract became impossible of performance, we think that the contract was legal when made, and that it may be enforced, unless the defendant shows the present impossibility of performance.

The order should be affirmed with $20 costs and disbursements, with leave to the defendant to answer within twenty days after service of order with notice of entry thereof, on payment of said costs.

Order unanimously affirmed with $20 costs and disbursements, with leave to the defendant to answer within twenty days after service of order upon payment of said costs. Order filed. All concur.[33]

(b) Effect on Shares: Treasury Stock

* * * Upon reacquisition of stock, a corporation may either retire it by an amendment of the certificate of incorporation and thereby decrease the number of authorized shares which may be issued, and cancel the certificates; or it may hold the certificates in the corporate treasury for a later resale. The latter is commonly known as "treasury stock".

Although reacquisition of its own stock by a corporation is prohibited in England, it has generally been permitted in the United States. * * *

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[33] Motion for leave to appeal denied, 259 App.Div. 714, 19 N.Y.S.2d 770 (N.Y.App. 1st Dep't, 1940).

Today, thirty-four states have statutes on the subject[34], and only five states do not have statutes or judicial decisions on the permissibility of reacquisition[35]. All but two states[36] permit reacquisition of stock.

When a corporation reacquires its own stock, there is a manifest effect on the corporate structure. Primarily, a purchase by a corporation of its own shares really amounts to a reduction of the company's assets, and the shares purchased are for all practical purposes extinguished until a reissue has taken place. This is obvious. For, when a corporation repurchases its outstanding shares, it expends a certain amount of its assets that might be used for other purposes.

Another change in the corporate structure is the reduction of voting rights. When a corporation acquires treasury stock, the existent voting rights of the stock are extinguished, by statute, for the period that the stock is held by the corporation.

A further effect is that on the issuance of dividends. The assets expended for the treasury stock are not again available for dividends. Therefore, if a corporation has $50,000 as "earned surplus" and repurchases five hundred shares of its outstanding stock at $100 a share, it has nothing available for a possible declaration of dividends.

The acquisition of treasury stock may be advisable for bona fide business reasons. It may be to retain an established policy of the corporation; the desire of a corporation to retire some owner, or the owner's own desire to relinquish his stock, when there is no outside market for his shares; to provide shares for employees under agreements that they will be stockholders during their terms of employment; or to compromise claims or debts owed to a corporation by its stockholders.

There are, however, many known abuses of the rights to acquire treasury stock. Among the more flagrant are those of selling treasury stock at prices less than the original par value or issue price, to avoid legal restrictions on *issuing* stock below par; to permit "insiders" to gain control by juggling the voting control of the corporation; to protect "insiders" by repurchasing their stock at inflated figures, when the corporation is on the verge of ultimate insolvency; to avoid the doctrine of pre-emptive rights; to create an artificial market and effect manipulations of the market price[37]; and, to deceive the public and stockholders by concealing the effect of purchases on surplus and capital by use of deceptive accounting methods.

The accounting profession generally uses one of four principal methods of entering treasury stock on the balance sheet. The stock may be carried (1) as an asset; (2) as a deduction from capital stock; (3) as a deduction from surplus; or (4) as a deduction from the total of capital stock and surplus. * * *

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34 Nemmers, Erwin E. "The Power of a Corporation to Purchase its Own Stock", 1942 Wisc.L.R. 161, 181.

35 Idaho, Mississippi, New Mexico, South Carolina, Wyoming.

36 New Hampshire by case law; Kentucky by statute, Carroll Ky.Stat.(1936) Sec. 544.

37 On 18 December 1933, the N. Y. Stock Exchange took a strong position opposing this practice. In part, its statement read: "The Committee on Stock List has

Other methods: A number of other methods have been advanced by authorities in dealing with this problem. Among them is "to show treasury shares simply as a deduction from the number of shares outstanding without any entry in the asset column or liability column of the balance sheet. The surplus will stand diminished by the amount of the purchase price, as in the case of a withdrawal by way of a dividend."[38] A variant is to follow the method of deducting from capital stock and surplus, and create a further reserve. By this method, the total in the Treasury Stock Account should be deducted from the total of capital stock issued and legally outstanding. "Earned surplus should be debited and an account called 'Reserve for Treasury Stock' should be credited with the actual amount of the cash paid out for the stock. The effect of this transaction is to reduce the Earned Surplus to the amount which is still available for dividends and to earmark the amount paid for treasury stock as unavailable for dividends until the stock has been reissued or cancelled, after which it should be restored to Earned Surplus."[39]

It is obvious, however, that these are but variations of the fundemental theory that a deduction should be made from both capital stock and surplus to present an accurate picture of the purchase and retention, however temporary, of the treasury stock. * * *

The general trend seems to be in favor of deducting from capital stock and surplus. The American Institute of Accountants has recommended that: "If any stock of the company is held in the treasury it should preferably be shown as a deduction from capital stock or from surplus or from the total of the two, at either par or cost, as the laws of the state of incorporation and other relevant circumstances require. If it is included on the asset side of the balance sheet the circumstances justifying such treatment should be indicated in the caption or in a footnote."[40] * * * [Note by Warren H. Schnur, Esq.]

CROSBY v. STRATTON.

Court of Appeals of Colorado, 1902. 17 Colo.App. 212, 68 P.130.

Action by Walter F. Crosby against Winfield S. Stratton. From a judgment in favor of defendant, plaintiff appeals.

THOMSON, J. Walter F. Crosby brought this suit against Winfield S. Stratton to recover damages from the latter for the alleged wrongful conversion by him of stock in the Portland Mining Company, to which the former averred himself to be entitled. The complaint set forth as follows: That the entire capital stock of the Portland Mining Company, a corporation, consisting of 3,000,000 shares, of the par value of $1 each, was at the date of the organization of the company, is-

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long urged corporations not to trade in their own shares. The Committee can see no justification whatsoever for a corporation using its assets to influence the market quotation of its own shares. Until recently, the practice of a corporation either trading in their own stock or reacquiring substantial amounts of their outstanding stock was unusual."

38 Ballantine, Henry W., "Ballantine on Corporations" 1946, rev. ed. p. 617.

39 Rosenkampf and Wider, "Theory of Accounts," p. 503.

40 "Examination of Financial Statements", issued by American Institute of Accountants, Jan., 1936.

sued, fully paid and nonassessable, in consideration of certain mining property then conveyed to the corporation; that afterwards, and prior to the 17th day of April, 1894, the stockholders of the company, of whom the plaintiff was one, transferred to the company 704,000 shares of this stock, to be held for its use and benefit, and to be part of its general assets; that this stock was not reported by the officers of the company as issued or outstanding, but as substantially unissued stock, not constituting part of the outstanding stock of the company; that the then stockholders, by virtue of their holdings, had each an undivided interest and right of property in and to the stock so turned into the company's treasury, equal to his proportionate ownership of the outstanding stock of the corporation; that on the 17th day of April, 1894, the plaintiff was the owner of 120,000 shares, and the defendant was the owner of 215,000 shares, of the then outstanding stock, and that the defendant then was, and continued to be, a director of the company; that on the last-named day the directors of the company, by resolution, authorized and directed the sale of the 704,000 shares which had been transferred to the company, for the price of 12½ cents per share, for the general purposes of the corporation; that, by virtue of the property of the stockholders in the stock so ordered to be sold, each stockholder, as incident to his ownership of outstanding stock, had the right to subscribe for, and to have allotted and issued to him, shares of the stock so ordered to be sold, in proportion to his then holdings; that of such stock the plaintiff was entitled to 65,000 shares, and the defendant to 117,424; that by reason of his office as director, and of his participation in the offer of the stock for sale, and the sale, the defendant was well acquainted with the rights of the stockholders in the stock to be sold; but, nevertheless, caused to be issued to himself 208,000 shares, an excess of 90,576 over the number to which, as a stockholder, he had any right; that, of those 90,576 shares, the proportion to which the plaintiff was entitled was 28,641 shares; that the plaintiff was, on the 17th day of April, 1894, and has ever since been, ready, able, and desirous to subscribe for, and have allotted to him, those 28,641 shares, but by reason of the wrongful act of the defendant in causing them to be allotted to himself, and holding and retaining them from the plaintiff, the latter has been unable to subscribe for, have allotted to him, or receive, those shares, or any of them, or any stock in lieu of them; and that on the 10th day of January, 1898, the plaintiff tendered to the defendant 12½ cents per share for each of the 28,641 shares, and demanded their delivery to him, but the plaintiff refused to comply with the demand. Judgment was demanded for $57,282, the alleged value of the stock withheld, and $13,461.27, the amount which the defendant was averred to have received as dividends earned by that stock. To the foregoing complaint, a demurrer was sustained, and, the plaintiff declining to amend, judgment was entered against him, and he appealed to this court.

The theory of the plaintiff, as outlined in the argument of his counsel, is that the stock transferred to the company, or, following an expression of counsel, covered back into the treasury of the company, became a fund, in the specific property constituting which all the stockholders were interested; that when the stock was offered for sale, it was

the right of each stockholder, upon payment of the price, to receive such number of shares as, upon a division of the stock among the stockholders in proportion to their respective holdings, would be allotted to him; and that when the defendant received 90,576 shares in excess of the number to which he had any right in virtue of his holdings, he took 28,641 shares to which a calculation of the plaintiff's proportionate interest in such excess shows the latter to be entitled. We shall first examine the complaint to see whether, on the plaintiff's theory that, as a stockholder, he had the right to subscribe, pay for, and receive a certain portion of the stock which had been transferred to the company, it states a cause of action against the defendant; and we shall afterwards inquire into the soundness of the theory. * * *

We come now to an examination of the underlying theory of the case. Had the original stockholders of the corporation any right, in law, to a preference over strangers in the purchase of the 704,000 shares they had transferred to the company, or had one stockholder any preference over another in the purchase? Such preference does exist in relation to original stock which remains untaken, and therefore unissued, at the time of the incorporation; and, in case of an increase of the capital stock, each of the first stockholders has the right to subscribe for and purchase his pro rata share of the new stock. One reason on which the rule in either case rests is that the stockholder has the right to preserve the proportionate interest in the corporation first acquired by him. To dispose of the unissued or added stock to strangers, or to other stockholders, without affording him an opportunity to take his pro rata share, would be, without his consent, to impair his interest and influence in the corporation, and diminish the relative value of his holdings; and this the directors, who are trustees for the stockholders, may not lawfully do. Agricultural Soc. v. Eichholtz, 45 Kan. 164, 25 P. 613; Jones v. Morrison, 31 Minn. 140, 153, 16 N.W. 854; Eidman v. Bowman, 58 Ill. 444, 447, 11 Am.Rep. 90; Reese v. Bank, 31 Pa. 78, 72 Am.Dec. 726; Sewell, J., in Gray v. Bank, supra; Atkins v. Albree, 94 Mass. 359; Angell & A. Corp. § 554. But because, to prevent impairment of their interests, corporators have a preference in the purchase of unissued or new stock, it does not follow that they have any right over strangers in the purchase of stock which has been paid for and issued, but transferred back to the corporation as part of its general assets. Their right in the one case is founded on reasons which have no existence in the other. The issued stock of a corporation represents its paid-up capital. The holder owns it and disposes of it as he sees fit; and if it finds its way back into the treasury of the corporation, it becomes assets in the same sense that the corporation's other property is assets. It is still part of the paid-up capital; and its sale no more affects the value of the other stock, or the standing of the stockholders in the corporation, than the sale of the corporation's tools or machinery. The relative value of all the stock is the same whether the particular stock of which we are speaking remains in the hands of the original holders, or has been acquired from them by the corporation, and placed in its treasury. In the case at bar, the entire authorized capital stock of the company had been issued and paid for in full. The hold-

ers transferred a certain portion of it to the company; for what purpose is not explicitly stated, but, upon a fair presumption from all the averments in the complaint, to be sold, and the proceeds used in the development of the company's property, to the enhancement of the value of the remaining shares. The complaint says that it was to be held for the company's use and benefit, and as part of its general assets. If that language means anything, it means that the stock was to be used, like the company's other assets, in furtherance of the objects of the corporation. And further on the complaint states that it was ordered to be sold for the general purposes of the company. It was paid-up stock when it was in the hands of the holders, and by its transfer to the company its character was not changed. The complaint says "that said stock was not, and was not reported by the officers of said company as, issued or outstanding, but as substantially unissued stock, not constituting part of the outstanding capital stock of the company, and the issue of said stock, at any time, making it participate in the assets, dividends, and control of the said company, would decrease the pro rata participation of the other stockholders in said company in the same ratio as the number of said unissued shares bore to the total capitalization of said company." One portion of the above we do not understand very well, and the other portion we do not understand at all. How a report by the officers of the company, whatever it might be, could make issued stock unissued stock, or could reverse the effect of facts, is what we fail totally to understand. The complaint furnishes no solution of the difficulty, and, in the absence of explanation, we must remain of the opinion that the character of the stock was unaffected by the report. If, by the succeeding language, is meant that the reissue of the transferred stock would have the same effect upon the value of individual holdings that would follow an issue of new stock or of original but hitherto untaken stock, then the pleader has given us the statement of a false proposition. It is true that by parting with a portion of his stock, the influence of the holder at corporate elections would be diminished, and in case of dividends he would receive less money; but the relative value of each individual share would remain the same. The amount of issued stock would not be changed, and the proportion between each issued share and the total number of issued shares would be preserved. This would not be the case if dormant stock were released, or existing values lowered by a dilution of new stock. The evident purpose of the transfer to the company was to enable it to raise money for the purposes of the enterprise in which it was engaged. If the stockholders had sold their stock on the outside for 12½ cents per share, and paid the money into the company's treasury, the desired result would have been accomplished as effectually as by the method which was employed. It is altogether immaterial whether the stockholders sold the stock themselves or turned it over to the company to be sold. In either case, they parted with all their interest in the stock, and put its further disposition entirely beyond their control. So far as our research has extended, the authorities are unanimous that where stock, once issued, returns to the possession of the corporation, upon its reissue

and sale the right of purchase of stockholders and strangers is the same. Hartridge v. Rockwell, R.M.Charlt. 260; State v. Smith, 48 Vt. 266; 1 Mor.Priv.Corp. § 455; 2 Thomp.Corp. § 2100. In Kimmell v. Geeting, 2 Grant, Cas. 125, there was a fraudulent combination and conspiracy among the defendants, who were the managers of the Sunset & Bedford Turnpike Company, to divide among themselves stock, the purchase of which for the benefit of the corporators they had directed by resolution. This case, although relied on by the plaintiff, is not in point. No conspiracy or fraudulent practice is charged in this complaint.

The demurrer was properly sustained, and the judgment will be affirmed.[65]

BORG v. INTERNATIONAL SILVER COMPANY

District Court of the United States, S. D. New York, 1924. 2 F.2d 910.

WINSLOW, DISTRICT JUDGE. This is a motion for a preliminary injunction restraining the defendants from issuing shares of its common stock, of the par value of $100 each, to the record holders of its preferred and common stock, at $50 a share, in the proportion of one share for every ten held. The defendant contemplates issuing to such stockholders, common and preferred, sufficient stock to raise approximately $300,000. Three other persons have asked permission to intervene as a committee under an agreement known as a stockholder's protective agreement, and have joined in the motion.

Under the offer made by the defendant, each holder of preferred and common stock will be entitled to one share of new stock for every ten shares of old. Exclusive of treasury stock, there are now issued 9,353 common and 60,285 preferred shares. The propriety of the issuance of 2,500 shares of this common stock is, however, questioned by the plaintiffs. The proposal of the defendant is contained in a circular letter, dated December 26, 1923, copy of which is attached to the bill herein. The stock thus offered to the stockholders of record is now held in defendant's treasury. The plan provides either payment is full on or before February 1, 1924, or, at subscribers' option, in installments, the last of which installments will fall due November 1, 1924. The circular further states that the money thus raised is needed for new buildings, machinery, and equipment.

The effect of issuing this common treasury stock would give the major portion thereof to the preferred stockholders. The temporary restraining order was issued pending the hearing and determination of the motion for the preliminary injunction. On the motion, the plaintiffs and the intervening stockholders represented 3,994 shares of common stock. The proposed action of the directors is challenged on the following grounds:

(1) The common stock proposed to be issued has in equity the status of retired stock, and cannot be issued at less than par.

[65] See In The Matter of Thomas Bond, infra 807.

(2) If it be held to have the status of treasury stock, then, as a matter of equity, the shares can be issued only upon such condition as will give to the holders of the common stock the first right to take the full amount at the price offered, and any amount which they do not take may contemporaneously be sold to the holders of preferred stock or to strangers.

(3) The sale of the stock is sought to be made in any event at an inadequate price. The burden is upon the directors to establish the adequacy of the price, as well as that the offer is made in good faith, because the directors are contracting with the corporation.

(4) The action is not taken in good faith because the dominant intent of the directors is to obtain common stock for the preferred stockholders, not $300,000 for the corporation.

The preferred stock of the defendant corporation is limited to 7 per cent. cumulative dividends and the payment of par in the event of dissolution and distribution. All earnings and surplus after the satisfaction of the claims of the preferred stockholders inure to the benefit of the common stock. The common stock which has a par value of $100, it is contended, has a book value of $480 a share. Whether or not this be true, it is conceded that the defendant corporation has a substantial actual surplus. In order to entitle the plaintiffs to the preliminary injunction, it is evident that they must show a case of probable right, or, in any event, that the balance of convenience justifies the issuance of such restraining order in order to maintain the status quo. It is manifest that the issuance of additional common stock at 50 cents on the dollar will materially decrease the surplus available to the common stock, and enable the preferred stockholders under the offer to acquire the major portion of the stock sought to be issued. The stock to be issued and now in its treasury was acquired by the defendant corporation through the purchase of the stock of the United States Silver Corporation in 1903, which corporation was the owner of this stock. The United States Silver Corporation was dissolved in 1908, the stock in question passed to the defendant. The defendant contends that this stock has not been retired or canceled as provided by the laws of the state of New Jersey, under which the corporation was organized. Therefore it is contended that the stock thus previously issued and now held by it in the treasury may be resold for the benefit of the defendant corporation.

It does not appear to be necessary on this motion to decide the precise question as to whether or not this stock was canceled by its reacquisition, but assuming that it was not, the directors in selling it are acting in a fiduciary capacity. The majority of the directors of the defendant corporation who voted for the proposal under discussion, were all holders of substantial amounts of preferred stock, but held no common stock. It is manifest that these directors cannot take any action which would injure one class of stock, even if no benefit were conferred upon the other class. If it be true—and it appears not to be disputed—that the corporation has a substantial surplus to which the preferred stockholders would not be entitled in the event of dissolution, then the action of the directors in making

an offer which results in the preferred stockholders getting the major portion of the proposed issue at 50 per cent. of its par value, would seem to work an injustice to the common stockholders. Whatever the intent of the directors may have been, the result is to confer specific benefits upon the preferred stockholders to the detriment of the common stockholders.

It is argued that no one has offered to pay more for it, and that there is no agreement as to what its market price, if any, may be. Indeed, it is asserted that 50 per cent. of its par is all it is worth: but apparently no effort has been made to get the par value of the stock, nor, indeed, to ask the common stockholders what they would be willing to pay. The price fixed would seem to be arbitrary. The burden is on the directors to prove that the price is adequate. Geedes v. Anaconda Copper Mining Co., 254 U.S. 590, 41 S.Ct. 209, 65 L.Ed. 425.

The inquiry naturally suggests itself to the inquiring mind whether or not the dominant motive is to distribute common stock to the holders of preferred stock, rather than merely to obtain $300,000 for the corporation. The parties all admit that without any difficulty whatever the corporation, with its financial standing, could readily borrow $300,000 on easy and convenient terms if its needs so require. It may be conceded, however, that no attack is made upon the sincerity of the directors' motives and their integrity, but such integrity of purpose in no wise changes the result of the issuance of the stock. The only detriment to the defendant resulting from the issuance of a preliminary injunction would be that, if resort is had to borrowing the money needed, interest would necessarily be paid. The denial of the injunction would, on the other hand, change the relation of the parties and might result in irreparable injury. The granting of the injunction will inflict upon the defendant only relative and small inconvenience.

The comparative injury would be greater to the plaintiff if refused than to the defendant if granted. Russel v. Farley, 105 U.S. 433, 26 L.Ed. 1060. The issuance of the stock will largely increase the outstanding common stock, and the book value at least of the shares held by the plaintiffs and those similarly situated would be materially reduced. The questions as to the status of the stock sought to be issued, whether canceled or held for cancellation, and whether or not the price is wholly inadequate as the plaintiffs contend, may be reserved until the trial of the cause.

For the reasons stated, I think the preliminary injunction should issue in accordance with the prayer; the plaintiffs, however, to give a bond in an amount to be fixed on the settlement of the order. The amount of this bond must be sufficient to protect the rights and interests of those affected thereby.[66]

[66] 1925, 20 Ill.L.Rev. 288.

BORG et al. v. INTERNATIONAL SILVER CO.

Circuit Court of Appeals of the United States, Second Circuit, 1925.
11 F.2d 147.

Appeal from an interlocutory decree[67] denying a motion for an injunction pendente lite. The suit was originally filed by the plaintiffs, common shareholders of the defendant company, to enjoin it from selling 6,000 shares of its common stock to shareholders, common and preferred, at $50 a share, in the proportion of one share for each ten of their existing holdings. The defendant conceded that this was to be only the first installment of sales by which it proposed to raise some $800,000 or $900,000 for its corporate purposes. The plaintiffs moved for a preliminary injunction against this proposed action, and the court enjoined the sale.[68] Thereafter the defendant publicly offered the same shares at open competitive sales to the highest bidders on sealed bids. The bill was then amended, and an injunction prayed against this second sale. On motion for preliminary injunction, the court refused so to order, and this appeal results.

The controversy depends, first, upon the question whether the common shareholders have a pre-emptive right to buy the shares; and second, assuming this not to exist, whether the defendant's directors are making the sale, not for the honest purpose of raising funds, but to secure the shares at less than their value. The defendant was organized in 1898 under the laws of New Jersey. * * * Its certificate authorized the issue of $20,000,000 of capital stock—$9,000,000 preferred, and $11,000,000 common. The common shares were to have no vote until January, 1902, and thereafter only at the rate of one vote for two shares as against the preferred's right of one vote for each share. * * * Defendant issued $5,107,500 of its preferred shares and $9,944,700 of its common. In 1902, $9,168,000 of the common shares and $515,000 of preferred, constituting a control, had come into the hands of a firm of the name of Thomas & Thomas, who conveyed them to a corporation organized by them for the purpose, known as the United States Silver Corporation. Thomas & Thomas also conveyed to their company certain shares of a Connecticut corporation, C. B. Rogers & Bros. Co., and these, with the shares in the defendant, constituted all the assets of that company.

Thomas & Thomas held all the capital stock of the United States Silver Corporation and $3,000,000 out of $3,150,000 of its bonds; the remaining $150,000 being issued to C. B. Rogers & Bros. Company. The defendant wished to obtain their interests, probably to prevent control of itself, and for that purpose bought all their holdings in the United States Silver Corporation by issuing to them $1,500,000 in new preferred shares of its stock, and $2,000,000 of its bonds (3,900,000 having been issued to others during 1898). This was towards the end of the year 1902, the transaction being finally consummated on January 7th of 1903.

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[67] 11 F.2d 143, D.C.N.Y. 1926.

[68] 2 F.2d 910, D.C.N.Y. 1924, supra, p. 698.

Thus matters stood until April 15, 1908, when the directors of the defendant passed a resolution that the company should acquire all the assets of the United States Silver Corporation "in consideration of an agreement by this company to assume, pay, and discharge all the debts, obligations, and liabilities of such corporation." On June 22, 1908, the defendant and its directors as sole stockholders of the United States Silver Corporation by unanimous consent dissolved that company under the New Jersey statute and acquired its assets, among them the shares of the defendant's stock formerly held by Thomas & Thomas, including $9,068,000 of the common. The shares to be sold are a part of the common shares so acquired.

Up to and including December 31, 1907, the balance sheet issued by the defendant had shown among its liabilities preferred shares amounting to $6,670,500, and common to $9,944,700. On December 31, 1908, this was changed, and the share liability read as follows:

Capital stock, preferred (issued)	$6,607,500.00	
Less in treasury	578,912.50	
		$6,028,587.50
Capital stock, common (issued)	$9,944,700.00	
Less in treasury	9,249,300.00	
		$695,400.00

A reduction was also made in the assets of over $11,000,000. * * * (Upon this balance sheet was a notation that the United States Silver Corporation had been dissolved, its assets transferred to defendant, which accounted for the reduction in the amount of outstanding stock.) * * *

On July 31, 1903, the defendant's board of directors passed an amendment to its by-laws (prohibiting the company from dealing in its own shares, except with the consent of two-thirds of the shareholders, either written or by vote at a special meeting. This was done so that defendant might secure quotation of its preferred shares among the unlisted securities of the New York Stock Exchange. The by-law was repealed in 1913.)

* * * The plaintiffs also alleged * * * certain conduct of the defendant's directors * * * showed their disposition to deal unfairly with the common stockholders. * * *

HAND, CIRCUIT JUDGE (after stating the facts as above). We do not see how it can be thought that the shares in question were in fact retired. The New Jersey statute (section 27, N.J.Corporation Law [P.L.1896, p. 277]),[69] prescribed a method by which this could be

[69] "The decrease of capital stock may be effected by retiring or reducing any class of the stock, or by drawing the necessary number of shares by lot for retirement, or by the surrender by every shareholder of his shares, and the issue to him in lieu thereof of a decreased number of shares, or by the purchase at not above par of certain shares for retirement, or by retiring shares owned by the corporation or by reducing the par value of shares * * * *provided*, no such decrease of capital stock shall release the liability of any shareholder, whose shares have not been fully

done, and there was no pretense of following it. As between the state and the defendant, the shares were certainly not retired. Knickerbocker Importation Co. v. State Board of Assessors, 74 N.J.L. 583, 65 A. 913, 7 L.R.A.,N.S., 885. We shall for argument's sake assume, without deciding, that the defendant might have so conducted itself as to create an obligation, presumably sounding in contract, with the common shareholders by which it was bound to treat the shares in question as retired, leaving the formalities to be observed later. Just what the consideration for such a contract could be, and how any implied promise could therefore become binding, we do not stop to inquire, since we think that from nothing shown can a promise be inferred of that purport. It is this which we consider.

The only substance which we can find in the plaintiffs' contention arises from the resolution of January 31, 1903. In the first place, it is clear that at least its purpose was quite different. Its origin shows that it was meant only to prevent the defendant from speculating in its stock. While nominally the shares here in issue were not its property on January 31, 1903, in substance they were. The defendant owned every title of proprietary interest in the shares of the United States Silver Corporation and all but $150,000 of its bonds. When it took formal action of dissolution and acquired the shares, it paid nothing for them, and did no more than make their status legally what it had in every other sense been before. This was not to speculate in its shares and would presumably not have been so regarded by the Stock Exchange. It is, indeed, argued that its purpose was irrelevant, if the language of the resolution covered the transaction; but this is not true. We are not concerned with whether, in the face of the by-laws, the shares could actually pass to the defendant; each side asserts that. Rather the question is what must be the reasonable inference of the defendant's intent from its action in taking them over. Upon that issue the purpose of the resolution, quite independently of its legal effect, is pertinent.

Assuming that the defendant is not to be presumed to act in contradiction of its own by-laws, such a presumption becomes a fiction when applied to a by-law which was clearly not intended to cover such a transaction, whatever its effect in law. The question being one of fact—i. e., the reasonable significance of the transfer—such considerations are relevant. Moreover, presumption against presumption, any deduction is canceled, because, if the common shares had been retired, or were bought to be retired, the resulting distribution between the common and preferred stock would have violated section 18 of the New Jersey Corporation Law,[70] a point we consider below in another connection. Thus at the outset we cannot see that there was any basis for the conclusion urged by the plaintiffs. * * *

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paid, for debts of the corporation theretofore contracted, nor effect any reduction of the taxes that may be required to be paid by the charters of corporations incorporated by special acts." Cf. N.J.S.A. § 14:11-5; N.Y.Stock Corporation Law, § 36.

[70] N.J.Corporation Law 1896, p. 277, § 18: "Every corporation shall have power to create two or more kinds of stock * * * but at no time shall the total amount of the preferred stocks exceed two-thirds of the actual capital paid in cash or property. * * *" Cf. N.J.S.A. § 14:8-1; N.Y.Stock Corporation Law, § 11.

So we think that the resolution created no presumption that the defendant intended to retire the shares. But, if it did, the presumption would be rebutted by what took place at the time and thereafter. It is clear, from the way in which it treated the shares in 1908 and afterwards, that the defendant did not suppose the shares were retired, or were to be. If so, it would not have carried them as treasury stock for 15 years. We can construe the balance sheets in no other way. The shares should not have appeared in the sheets at all, or, if they did, only as held for retirement. To mark them as held "in treasury" was to ticket them as treasury shares; it could mean nothing else. The original note on the sheet for 1908 does not say anything to the contrary; they were not "outstanding," because they were held by the defendant; to be "outstanding," they must be effective obligations against it.

Against this it is argued that the shares should have been carried among the assets either at cost—as prescribed by the Interstate Commerce Commission—or at par, and that the assets should not have been reduced. The affidavits are not clear as to the most approved way of carrying treasury shares, and anyway we think the issue immaterial. Such shares are of necessity retired in this sense: That they constitute no longer any liability of the defendant. A corporation can have no right of action against itself, as must be if the share is truly a liability. Indeed, the only difference between a share held in the treasury and one retired is that the first may be resold for what it will fetch on the market, while the second has disappeared altogether. Enright v. Heckscher, 240 F. 863, 874, 153 C.C.A. 549, C.C.A. 2; Rural Homestead Co. v. Wildes, 54 N.J.Eq. 668, 35 A. 896; Cook on Corporations, § 286. Therefore the best way to state the facts in the corporation's accounts is merely a matter of form, and it can make no difference in the case at bar how it was done, so long as the intent appears.

To carry the shares as a liability, and as an asset at cost, is certainly a fiction, however admirable. They are not a liability, and on dissolution could not be so treated, because the obligor and obligee are one. They are not a present asset, because, as they stand, the defendant cannot collect upon them. What in fact they are is an opportunity to acquire new assets for the corporate treasury by creating new obligations. In order to indicate this potentiality, it may be the best accounting to carry them as an asset at cost, providing, of course, all other assets are so carried. Even so, a company which revalued its assets might properly carry them at their sale value when the revaluation was made. In any event there can be no ambiguity in stating the facts more directly, as the defendant did; that is, in treating the shares as not in existence while held in the treasury, except as a possible source of assets at some future time, when by sale at once they become liabilities and their proceeds assets. It makes no difference whether this satisfies ideal accounting or not. * * * We do not understand that they maintain that shareholders have a pre-emptive right in treasury shares. If so, the cases, of which there are not many, are against them (Enright v. Heckscher, 240 F. 863, 874, 153

C.C.A. 549, C.C.A. 2; Page v. Smith, 48 Vt. 266; Hartridge v. Rockwell, R.M.Charlt. [Ga.] 260; Crosby v. Stratton, 17 Colo.App. 212, 68 P. 130; Cook on Corporations, § 286), though the right is well settled when new shares are sold after an increase of capital stock (Stokes v. Continental Trust Co., 186 N.Y. 285, 78 N.E. 1090, 12 L.R.A.,N.S., 969, 9 Ann.Cas. 738; Electric Co. v. Edison etc., Co., 200 Pa. 516, 50 A. 164; Way v. American Grease Co., 60 N.J.Eq. 263, 269, 47 A. 44; Gray v. Portland Bank, 3 Mass. 374, 3 Am.Dec. 156).

The distinction may appear tenuous, but rests upon the effect which a new issue has upon the voting control of the company. When a person buys into a company with an authorized capital, he accepts that proportion of the voting rights which his purchase bears to the whole. This applies certainly so far as the other shares are issued at the same time, and perhaps, also, though they are issued much later. But treasury shares have by hypothesis once been issued, and have diluted, as it were, the shareholder's voting power ab initio. He cannot properly complain that he is given no right to buy them when they are resold, because that merely restores the status he originally accepted. All he can demand is that they shall bring to the corporate treasury their existing value. If they do, his proportion in any surplus is not affected. However, when the capital stock is increased beyond the original amount authorized, the voting power is diluted along with it; the shareholders who had not originally bought into so large an issue may insist that the old proportions be observed. To deprive them of their right of pre-emption is to change their contract. At any rate it is only on this theory that any right of pre-emption exists, and since the shares at bar were never bought to be retired, and the capital was not increased, the right does not exist. * * *

Order affirmed.[71]

2. REDEMPTION AND RETIREMENT

NOTE

Not infrequently, corporate charters contain provisions permitting preferred stock to be retired or redeemed on call by the corporation at a fixed redemption price. Following is a typical clause:

REDEMPTION (PAR VALUE)

The corporation may at the option of the board of directors, redeem the whole or any part of the outstanding preferred stock on any dividend payment date after ——— by paying ——— Dollars ($———) for each share thereof, together with a sum of money equivalent to dividends at the rate of ——— per centum (———%) per annum on the par value thereof from the date on which the dividends thereon became cumulative to the date fixed for such redemption, less the amount of dividends theretofore paid thereon.

Notice of such election to redeem shall, not less than thirty (30) days prior to the dividend date upon which the stock is to be redeemed, be mailed to each holder of stock so to be redeemed at his address as it appears on the books of the corporation.

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71 1927, 36 Yale L.J. 1181.

In case less than all of the outstanding preferred stock is to be redeemed, the amount to be redeemed and the method of effecting such redemption, whether by lot or pro rata or otherwise, may be determined by the board of directors. If on or before the redemption date named in such notice, the funds necessary for such redemption shall have been set aside by the corporation so as to be available for payment on demand to the holders of the preferred stock so called for redemption, then, notwithstanding that any certificate of the preferred stock so called for redemption shall not have been surrendered for cancellation, the dividends thereon shall cease to accrue from and after the date of redemption so designated, and all rights with respect to such preferred stock so called for redemption including any right to vote or otherwise participate in the determination of any proposed corporate action, shall forthwith after such redemption date cease and determine, except only the right of the holder to receive the redemption price therefor, but without interest. Stock redeemed pursuant to the provisions hereof shall not be reissued but shall be cancelled.

RETIREMENT AND REDUCTION OF STOCK.

A real distinction exists financially between the redemption, retirement, or purchase of preferred stock, and the redemption, retirement, or purchase of common stock.

The process of paying off a preferred shareholder and calling in a share of stock is analogous in financial practice to paying off a note. It cannot be done unless there is an agreement permitting such retirement, or unless a preferred stockholder agrees to turn in his stock.

"Redemption" normally means the calling in of a share of the preferred stock pursuant to a clause in the certificate permitting this. Normally preferred stock is redeemable at a price slightly higher than the amount paid for it by the shareholder on original issue—the premium being to compensate him for the loss of his shareholder's position, which may or may not be valuable. This permits a corporation to issue a preferred stock when money rates are high, carrying a dividend of say 8 per cent.; and, when money rates are lower, to redeem preferred stock and issue another preferred stock at say 6 per cent., saving the difference in dividends.

"Retirement" is another word for the same operation; but retirement usually connotes that the share thus paid out can never be reissued, but is "killed."

"Purchase" consists in buying preferred stock in the open market; but not pursuant to an option or privilege retained by the corporation in the certificate of incorporation. The law normally requires the purchase price of a share of stock to be paid out of surplus.

With common stock there is no such simple financial justification. The usual motive for purchasing common stock (which normally cannot be retired or redeemed) is the desire of the corporation or someone in it, either

(a) to eliminate some one man as an objectionable associate; or

(b) to reduce the number of participants outstanding on the theory

that this will enhance the pro rata profits applicable to the remaining shares.

Less honestly, of course, the power may be used to create fluctuations in the market.

Historically, shares could not, in America at least, be redeemed, retired, or purchased out of capital; the theory being that the creditors of the corporation were entitled to be paid before a single dollar of capital was repaid to the shareholders.

As the conception of preferred stock as a substitute for notes and bonds began to appear, statutes not infrequently permitted corporations to redeem, retire, or purchase their preferred stock, and write-off a prescribed amount from their capital account. Corporations desire to do this in normal course so as to preserve a large surplus available for dividends on the common stock.

WESTERFIELD-BONTE CO. v. BURNETT.

Court of Appeals of Kentucky, 1917. 176 Ky. 188, 195 S.W. 477.

HURT, J. The appellant, Westerfield-Bonte Company, is a corporation organized under the corporation laws of the state of Kentucky, with its home in the city of Louisville. The capital stock consists of two hundred and fifty shares of the par value of one hundred dollars each. Sixty shares of the capital stock, of the par value of one hundred dollars each, are what is denominated preferred stock, and the remainder of the shares are what is known as common stock. At the creation of the corporation all of the stock was what is denominated common stock, but on the 4th day of June, 1910, amended articles of incorporation were adopted, in the manner provided by law, by which it was provided that sixty shares of the capital stock should be of the class known as preferred stock, and the remainder should be common stock. These amended articles were adopted by the unanimous action of all the holders of the capital stock of the corporation. The amended articles provided as follows:

"The preferred stock may, by vote of the majority of the board of directors of said company, be redeemed on any dividend date, as fixed by the by-laws, at any time after one year from the first day of July, 1910, at the price of one hundred and five dollars ($105.00) per share, and any accumulated dividends, and this preferred stock shall, upon request to the board of directors of said company from the holders of two-thirds thereof, be retired at the price of one hundred dollars ($100.00) per share, and any accumulated dividends, at any time after July 1st, 1915." * * *

[The certificates stated that the preferred stock was part of a $6,000 par value issue, and that the holder was entitled to an 8% cumulative dividend.]

The appellee, Henry Burnett, became the owner of forty shares of the preferred stock, which was two-thirds of it, and on July 28, 1915, made a demand in writing to the board of directors of appellant, by which he requested it to retire the preferred stock, which he held, and

to pay him therefor the sum of one hundred dollars per share, with interest at eight per centum per annum from July 1, 1915. The demand was acknowledged by the board of directors, but it refused to retire the stock or redeem the same, as provided by the articles of incorporation. The appellee, on October 15, 1915, instituted this action and in addition to the above stated facts, alleged that the corporation was amply able to retire his stock and to pay him the sum necessary for that purpose, according to the articles of incorporation, without detriment or danger to the rights of appellant's creditors, and that appellant did not owe anything beyond its current bills, and that the rights of its creditors would not be in any manner injuriously affected.

The appellant, by answer and two amendments thereto, denied that the effect of the articles of incorporation was to authorize the appellee to demand the retirement or to receive the par value of his preferred stock, so long as the corporation was a going concern, except that the preferred stock might be redeemed out of the surplus funds of the corporation and without infringement upon its capital stock, and denied that the preferred stock was entitled to any preference over the common stock, except in payment of dividends or upon a final dissolution of the corporation to be redeemed out of the assets of the corporation before the common stock should be redeemed. A denial was made that the corporation had no indebtedness beyond its current bills, or that the rights of the creditors would not be jeopardized by the payment of the appellee's claim without danger or detriment to the rights of its creditors. The answer, also, alleged that the regular dividends provided for had been regularly paid upon the preferred stock until January, 1915; that the corporation had no money or property of any kind, except its machinery, equipment and supplies used in the conduct of its business; that it had $3,903.55 face value of accounts, worth sixty per centum of their face value, and that its average amount of cash on hand was about two hundred and fifty dollars; that its pay-roll was about two hundred and fifty dollars per week, and that in order to raise the money necessary to retire the preferred stock and to pay appellee's claim it would have to sell or mortgage its property; that its machinery, equipment and supplies cost originally twenty thousand dollars, but some of it was several years of age and while valuable to a going concern, would probably sell for only a small percentage of its original cost; and that the corporation owed debts to the amount of fifteen hundred dollars, and that two hundred dollars par value of its common stock had never been subscribed for nor sold. The answer, furthermore, set out in full the amended articles of incorporation heretofore referred to, bearing upon the preference provided, for the preferred stock in the payment of dividends, and the redemption of the shares, upon a final dissolution.

A general demurrer was interposed and by the court sustained to the answer as amended. Before the submission of the case, however, the appellee took the deposition of the president of the corporation and by him it was shown that after the redemption of the entire preferred stock, and the payment of all creditors of the corporation, there

would be a surplus of assets for distribution among the common stockholders of something between 12 and 15 hundred dollars. * * * [After trial, the court held for plaintiff for $4,197.33 with 6% interest on the ground that creditors would not be injured by requiring the corporation to redeem plaintiff's preferred stock. Defendant appeals from this judgment.]

It is an undisputed doctrine, that corporate property must first be appropriated to the debts of a corporation before there can be any distribution of it among the stockholders, holding either preferred or common stock, as both classes of stock are equally liable to the creditors of the corporation. There can be no lawful distribution of the capital of the corporation among the stockholders, without the corporate debts having been first paid or provided for, but in the absence of any creditors, or where provision has been made for them or exists for them, the rights of the preferred stockholder depends upon his contract with the corporation. 7 R.C.L. §§ 170, 171. A judgment should not be rendered, by which any of the assets of a corporation are appropriated to the payment of any claim of a stockholder growing up out of a contract for a preference among the stockholders, if such appropriation would endanger the collection of the corporate debts. The corporation, however, is the property of the stockholders, and if they contract in such a way as to be legally bound to appropriate a portion of the capital to redeem the share of the preferred stockholder, the contract may be enforced, if the enforcement does not affect the collection of the claims of the creditors of the corporation. In the instant case, the rights and remedies of any creditor of the corporation, either against the corporate property or against a preferred stockholder, whose stock might be redeemed out of the assets of the corporation, or who might receive the proceeds of the sale of the corporate property, are not here determined, as the questions are not before us upon the record, but suffice it to say, that the answer failed to show that the enforcement of the contract of appellee with the corporation would endanger the collection of the corporate debts. Hence, the judgment sustaining the demurrer is affirmed. It may be added, that the deposition of the president of the corporation, which is made a part of this record by appellant, affirmatively shows that after the redemption of the preferred stock and the payment of all the corporate debts, there will be a surplus equal to the amount of the corporate debts, of the assets of the corporation left for distribution among the stockholders.

The judgment is therefore affirmed.

GENERAL INVESTMENT CO. v. AMERICAN HIDE & LEATHER CO.

Court of Errors and Appeals of New Jersey, 1925.
98 N.J.Eq. 326, 129 A. 244, 44 A.L.R. 60.

[Defendant corporation was organized in New Jersey in 1899 with an authorized capital stock of $35,000,000, divided into common and preferred $100 par stock. 125,483 shares of 7% cumulative voting

preferred and 112,741 voting common shares were issued, 111,776 unissued shares remaining in the corporate treasury.

Plaintiffs own 7% cumulative preferred stock, upon which there was a 140% default in dividend payments.

The corporation, at the time of suit, had a surplus of $5,000,000.

The board of directors, three-quarters of the preferred and seven-tenths of the common stock voted in favor of the following plan: (1) to reclassify 35,000 unissued preferred shares into 35,000 8% cumulative prior preference shares, preferred as to principal and dividends over the outstanding preferred and common stock, redeemable any time after three years at 15% above par; (2) to decrease the total capital stock by about $10,000,000 by canceling 10,000 preferred and 60,000 common shares now in the treasury; (3) to purchase for retirement and cancellation 30,000 outstanding preferred shares at not above par (thereby canceling $4,200,000 accrued dividends); to purchase from the Chase Securities Co. (holder of 15,000 preferred shares) its holdings at about $69 per share, to be paid from surplus.

The outstanding capital stock would then be approximately:

1st preference 8% cumulative (new)	$ 3,500,000
Cumulative 7% preferred (remainder of old stock.)	$6,500,000
Common stock (approximately)	$11,500,000

Plaintiff filed a bill for an injunction restraining the execution of the plan on the ground that: (1) the issue of 8% cumulative prior preferred stock violates the vested rights of the existing preferred stockholders; (2) the preferred stockholders are entitled to sell their holdings pro rata for retirement; (3) the corporation cannot apply accrued dividends belonging to preferred stockholders, to the purchase; (4) the redemption provision is invalid.

Plaintiff appeals from the denial of a preliminary injunction.]

GUMMERE, CHIEF JUSTICE. * * * The next point submitted by counsel for the appellants is that they are entitled to be afforded an opportunity of selling to the corporation for retirement their pro rata holdings of the total amount of shares, the purchase of which is contemplated, and that this right is injuriously affected by the preference given to the Chase Securities Corporation in the making of such purchase. We concur in the view that, in the purchasing of this stock for retirement, it should be acquired ratably from each stockholder who desires to sell. It was so held by us in the Berger Case, 63 N.J. Eq. 506, 53 A. 14; and, if it be true that the proposed scheme is in violation of that right—which seems, at least, doubtful—the respondent company should be restrained from refusing to afford the complainants the opportunity to dispose of their stock to the corporation to the extent indicated. * * *

* * * the order appealed from will be affirmed, with the modifications indicated. * * *

NOTE

The court will enjoin the consummation of a promise to certain preferred stockholders to repurchase their stock at par, where no such agreement was made with

all preferred shareholders, even though the corporation has the power to contract to repurchase its stock. All preferred stockholders must be treated equally. Hoops v. Leddy, 119 N.J.Eq. 296, 182 A. 271, 1936; 1936, 3 U. of Chi.L.Rev. 665.

If a corporation, by a majority stockholders' vote, resolves to retire its preferred stock and issue new preferred stock, a dissenting stockholder is entitled to have his shares appraised and bought in, if there is any question as to whether the stockholders are benefited by such change. Matter of Silberkraus, 250 N.Y. 242, 165 N.E. 279, 78 A.L.R. 1113, 1929; Matter of Seiler, 239 App.Div. 400, 267 N.Y.S. 567, 1st Dep't., 1933; Note, Capital Reclassification as an Alteration of Preferential Rights under Appraisal Statutes, 1933, 42 Yale L.J. 952.

A corporation was authorized to issue preferred stock redeemable at $105 per share. Complainant contended the redemption provision violated a statute prohibiting a corporation from purchasing its own stock. *Held:* the authorization was to redeem, not purchase, its stock; that "redemption means retirement of the stock redeemed", and was therefore valid by statute. Venner v. Public Utilities Comm., 302 Ill. 232, 235, 134 N.E. 17, 1922. But see Borg v. International Silver Co., *supra*, p. 701, which holds that where a corporation purchases its own shares and holds them in its treasury, there is no presumption that such shares were bought for retirement.

TAYLOR v. AXTON-FISHER TOBACCO COMPANY.

Court of Appeals of Kentucky, 1943. 295 Ky. 226, 173 S.W.2d 377.

Declaratory judgment action by Charlotte Taylor against the Axton-Fisher Tobacco Company to determine the power of defendant's board of directors to modify its action in calling defendant's Class A Common stock for retirement. From an adverse judgment, plaintiff appeals. Reversed.

STANLEY, COMMISSIONER. The case presents a novel question of power of the board of directors of a corporation to rescind or modify its action in calling certain stock for redemption or retirement.

The Axton-Fisher Tobacco Company, a Kentucky corporation, has or had three classes of stock, which are designated as Preferred, Class A Common and Class B Common. The preferred stock (13,698 shares outstanding) bears cumulative dividends at the rate of 6 per cent per annum. Class A Common stock (15,397 shares outstanding) bears cumulative dividends at the rate of $3.20 per share per annum and has other substantial rights. Class B Common stock (142,080 shares outstanding) has the sole voting power in the management of the corporation except in the event of default in the payment of as many as four quarterly dividends on either of the other two classes. The Preferred stock has first right to dividends. It is not involved in the case. Class A Common stock has few of the attributes of ordinary common stock, it being of the nature of secondary preferred stock. The character and general rights of these respective classes of stock are described in Franke v. Axton-Fisher Tobacco Co., 289 Ky. 687, 160 S.W.2d 23, and, in the particular respect involved, in the further course of this opinion.

The articles of incorporation contain a provision that all or any part of the Class A Common stock, at the option of the directors, upon

sixty days notice, may be redeemed on any quarterly dividend-payment date by the company paying $60 a share therefor, and all accrued unpaid dividends. If less than all the stock be retired, all stockholders of the class must be treated alike. On April 3, 1943, the board of directors adopted a resolution reciting that pursuant to the above provision of the charter the entire outstanding Class A Common stock was called for redemption on July 1, 1943 at $60 per share plus the accrued unpaid dividends thereon, including one payable July 1st, amounting to $20.80 per share, an aggregrate of $80.80. A trust company was named as redemption agent and the officers of the corporation were authorized and directed to deposit $1,244,077.60 with the trust company as a special fund with which to effectuate the redemption.

On June 16, 1943, the directors adopted a resolution modifying their previous action and changing the call for the retirement of Class A Common stock from a mandatory to an optional one, leaving it to the option of the holders thereof whether they would surrender the stock for redemption on July 1st upon the same terms or would retain it without impairment of the rights appertaining thereto.

A holder of a small amount of Class B Common stock instituted this suit for a declaratory judgment respecting the power and right of the directors to modify the action of April 30th. She denied such power. The circuit court declared it was a proper exercise of power. On the appeal the Transamerica Corporation, claiming to be the owner of about 85 per cent of the Class B Common stock and none of Class A (having previously exchanged what it owned, a very large amount, for Class B) has joined the plaintiff on the appeal by filing a brief as amicus curiæ challenging the validity of the action of the board and the correctness of the judgment.

On first impression it would seem clear that the directors had a perfect right to change their minds, and that their action in modifying the first call for redemption was but a decision made in the course of management, well within the common law and statutory powers of a board of directors of a corporation in their discretion to manage its affairs intra vires. It is fundamental and elemental that the action of directors when exercised in good faith and not in fraud of the rights of the stockholders is not subject to their control and will not be interfered with by the courts. KRS 271.230; Manufacturers' Land & Improvement Co. v. Cleary, 121 Ky. 403, 89 S.W. 248; Reid Drug Co. v. Salyer, 268 Ky. 522, 105 S.W.2d 625; Fletcher, Cyclopedia of Law of Private Corporations, §§ 505, 2104. It would also appear that the power to recall or modify the original action existed until July 1st, as of which date the redemption would be consummated; and, further, that Class A stockholders alone might have complained of the modification but for the fact they were not prejudiced thereby. These are the essential arguments of the appellee.

The general and necessary conception of power and right of exclusive management in the directors, obviously, is subject to the elementary principle that if in a particular instance their action created rights in another they cannot alter or affect those rights to his prejudice. The first resolution of this board of directors materially changed

the entire corporate structure. It changed the status of both holders of Class A and Class B common stock, very definitely and directly. The question is whether the new status could be altered. The subsequent resolution of June 16th did not effectually disturb that changed status of Class A stockholders for they had the right to continue it; but it could not and did not give any choice to the Class B stockholders.

The rights of the holders of Class A stock and of the corporation as to its redemption rested on an express contract, namely, the provision of the articles of incorporation which made them junior preferred stockholders and subject at all times to have their stock retired. [Citing cases.] * * *

We have a declaration of principle in Fox v. Johnson & Wimsatt, 75 U.S.App.D.C. 211, 127 F.2d 729 (an opinion by Mr. Justice Rutledge, presently of the Supreme Court) directly pertaining to the Class A stockholders and indirectly to Class B. A preferred stockholder sued for specific performance of a resolution of redemption of the class of stock he owned. It was stated that by the provision of the charter giving the corporation the right to redeem the stock the shareholders in effect contracted that their shares should be redeemable at the corporation's option. It was held that the stockholder could not enforce the redemption until the directors had exercised the option definitely and contractually in accordance with the power conferred on them. The denial of specific performance was rested on the ground that the resolution of the directors merely declared a policy of redemption and was conditional, so the stockholder's contractual right did not mature into an enforcible one because of the character of the action of the board and the conditions had failed to materialize. * * * Indeed, it is conceded by the appellee that the action of the directors on April 30th vested rights in the holders of Class A stock which could not have been voided. We think if it vested rights in one class it did in the other for the reasons to be stated.

We should not test the rights inuring to the holders of Class B stock by the fact that the later resolution made it optional with the Class A stockholders to accept or reject redemption, hence that they were not prejudiced. It may be reasonably presumed that at least some of them will accept it. The question is was the first change made in the status of Class B shareholders revocable without their consent, or did they acquire a vested right under the resolution making it obligatory on Class A stockholders to redeem their stock and sever all relationship to the corporation. This is to be determined by an examination of the charter rights of holders of Class B stock as affected by the charter rights of holders of Class A stock. They are fairly stated by the amicus curiæ to be: (1) The right to cumulative dividends on the $10 par value of $3.20 per share per annum, plus an amount payable to all of the holders of Class A stock as a class equal to the total of any additional dividend declared in any year in excess of $1.60 per share on all of Class B stock; (2) The right to vote at the stockholders' meetings so long as their dividends were in default; (3) The right, unless the holders of two-thirds thereof consented, to prevent the corporation from (a) incurring an indebtedness maturing later than

twelve months other than in the ordinary course of business, or (b) mortgaging or pledging property to secure an issue of bonds, or (c) disposing by sale, consolidation, mortgage, lease or otherwise the property and business of the corporation as a whole; (4) The right in the event of dissolution, liquidation, merger or consolidation or sale of substantially all of the corporate assets, to receive per share twice the amount paid upon each share of Class B stock; and (5) The right, in the event of redemption, to receive all accrued and unpaid dividends and the sum of $60 per share.

Manifestly, it was very much to the interest of the holders of Class B stock to have all these priorities, obligations and restrictions on and conditional joint control of the management eliminated. A substantial advantage was given to and acquired by the Class B stockholders by the resolution definitely and unqualifiedly calling Class A stock for redemption. That being true, it was vested and fixed, so the directors could not withdraw or cancel or modify their action to the prejudice or detriment of Class B stockholders.

The first action of the directors may not be regarded as but an offer or proffer, or in the nature of such, capable of being withdrawn before acceptance or consummation. Rather it is the converse. The charter provision constituted a continuing contractual power and corresponding right which only waited action by the directors for use and consummation. It was a continuing option. They exercised their authority and thereby closed the matter insofar as it concerned the corporation and the two classes of stockholders affected thereby. It made Class A stockholders strictly creditors and thereby freed the Class B stockholders of the restrictions on management and of the subordination to the right to share in the earnings of the company.

Nor can we agree with the appellee that the result of this action of the directors is to be regarded only as an incidental benefit flowing to the Class B stockholders since they were not promisees of the contract nor parties to whom performance was to be rendered. See 2 Williston on Contracts, § 402. The provision of the articles of incorporation and the effect of the action of the directors are too substantial and too great to be so regarded. We think the provision for redemption of Class A stock was made as much for the one as for the other class. If it was not, then it was very delusive.

The principle applicable in cases where there has been a declaration of dividends is applicable here. Undivided profits of a corporation in a sense or qualifiedly belong to the stockholders, but disposition or distribution thereof rests within the fair discretion of the directors. Smith v. Southern Foundry Co., 166 Ky. 208, 179 S.W. 205. However, once they make a declaration of distribution or dividend and set apart a fund for the payment, their power is exhausted in the particular instance and their action is irrevocable without the consent of the stockholders. As respects the dividend, they have been changed from stockholders to creditors. Until the declaration of the dividend, the stockholders had only a potentiality. Afterward they have a vested right in the money and may maintain an action at law to enforce it. [Citing cases.] * * *

It seems to us that the rationale upon which rests this right to enforce collection of a declared dividend controls the decision of this case, namely, that the status of both classes of stockholders was changed. What were potential rights in Class B stockholders became vested rights by the first action of the directors. Class A stockholders were eliminated as of July 1st, 1943, for they could not at the same time be stockholders and creditors in relation to the same funds. In re Phœnix Hotel Co., 6 Cir., 83 F.2d 724. Class B stockholders thereby acquired the rights above described. The rights of the one nor the other could be impaired or modified without their consent. We are of opinion, therefore, the circuit court should have so declared and adjudged.

The judgment is reversed.

NOTE

"Ordinarily the redemption is at the option of the company, and so is unobjectionable, for it is of concern to the corporation not to allow prior liens to pass beyond recall, and in case of a conflict between interests, it may be of advantage for the corporation to buy out the dissenting element by redemption of its stock. A redemption, however, compulsory at a certain date or the power granted to the preferred stockholder to convert himself into a creditor and demand cash if dividends are not paid, has been disallowed by the courts where the assertion of such a power by the preferred stockholder would militate against creditors." Note, 1927, 27 Col.L.Rev. 587, 591. See, also, Dodd, Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law, 1941, 89 U. of Pa.L.Rev. 697, 719–734; Jones, Redeemable Corporate Securities, 1931, 5 So.Calif.L.Rev. 83; Notes, 1934, 88 A.L.R. 1131; 1940, 124 A.L.R. 1069; 1935, 83 U. of Pa.L.Rev. 888; 1933, 8 Ind.L.J. 442.

The holder of preferred stock, redeemable on a day certain, is not converted into a corporate creditor on the redemption date so as to entitle him to priority on the dissolution of the corporation. Vanden Bosch v. Michigan Trust Co., 35 F.2d 643, C.C.A.Mich.1929; 1930, 28 Mich.L.Rev 764; Hazel Atlas Glass Co. v. Van Dyk & Reeves, *supra*, p. 505.

A preferred stockholder has no right to have the corporation return his money with interest when the financial condition of the company is such that it is unable to pay its debts. Rider v. The John G. Delker & Sons Co., 145 Ky. 634, 140 S.W. 1011, 39 L.R.A.,N.S., 1007, 1911; Warren v. Queen & Co., 240 Pa. 154, 87 A. 595, 1913. See, also, 1932, 17 Marq.L.Rev. 229.

On the right of Class B preferred stockholders to exercise their option of redemption, over the objection of Class A preferred stockholders, see Crimmins & Pierce Company et al. v. Kidder Peabody Acceptance Corporation et al., 282 Mass. 367, 185 N.E. 383, 88 A.L.R. 1122, 1933.

On the power of a corporation to redeem preferred stock from funds created by a sale of corporate assets, see Hildreth v. The Western Realty Company, 62 N.D. 233, 242 N.W. 679, 1932.

F. REDUCTION OF CAPITAL

New York Stock Corporation Law, § 36:[1] "A stock corporation may effect one or more of the following purposes: * * * (A) To increase or reduce the amount of its capital stock where all of the capital stock is divided into shares having a par

[1] The complete section appears infra, p. 1329. Note that the section intermingles with the reduction provisions, provisions permitting change and reclassification of shares.

value; * * * (G) To reduce its capital so as to eliminate therefrom any or all of the amount thereof previously transferred thereto by resolution of the directors: or, if desired and without limitation of the corporation's power to reduce its capital in any other lawful manner, to reduce such capital to a specified amount in connection with any change, reduction of par value or elimination of shares, or other proceeding to be accomplished by the certificate: By filing a certificate which shall * * * state: * * * 8. * * * the amount to which (the capital) is reduced * * * 16. If it be proposed to reduce the amount of capital pursuant to paragraph (G), the certificate shall provide that the surplus, if any, resulting from such reduction shall be available for any one or more of the following purposes:[3] (a) to be used for any purpose for which surplus may be used; or (b) to be reserved and used for specified purposes; or (c) to be returned to the stockholders, according to their respective rights, at the times and in the manner specified."

New York Stock Corporation Law, § 37, requires that the reduction of capital stock be approved by a majority vote of the holders of outstanding voting shares, and that an affidavit of the corporate officers be attached to the certificate of reduction stating: sec. 37(4): "either (a) that no distribution of assets to the stockholders will be made in connection with the proposed reduction, or (b) that the actual value of the assets of the corporation is not less than the total amount of the debts and liabilities of the corporation plus the proposed amount of its capital".

DELAWARE GENERAL CORPORATION LAW

Sec. 28. *Reduction of Capital:*—Any corporation organized under this Chapter may reduce its capital at any time (a) by the written consent of the holders of record of the total number of shares of the corporation having voting powers at the time outstanding or (b) by resolution of its board of directors supplemented by a resolution adopted by the holders of record of a majority of said shares at a meeting of the stockholders called for that purpose upon at least ten days' notice given in accordance with the by-laws of the corporation to said stockholders. Any preferred or special shares which have been called for redemption and the payment of the redemption price of which has been provided for shall not be deemed to be outstanding. A certificate stating the fact of such consent or the adoption of such resolution and specifying the manner and the extent to which the capital of the corporation is to be reduced shall be made under the seal of the corporation and the hands of its President or a Vice-President and its Secretary or an Assistant Secretary and the President or such Vice-President shall acknowledge said certificate before an officer authorized by the laws of Delaware to take acknowledgments of deeds; and the certificate, so executed and acknowledged, shall be filed in the office of the Secretary of State and a certified copy thereof shall be recorded in the office of the Recorder of the County in which the original Certificate of Incorporation is recorded. Upon the completion of such filing and recording the capital of the corporation shall thereby be so reduced. No such reduction, however, shall be made in the capital of the corporation unless the assets of the corporation remaining after such reduction are sufficient to pay any debts, the payment of which

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[3] N.Y.Stock Corporation Law, § 38(4): "No corporation, except as otherwise provided by law, shall make any distribution of its assets in connection with the reduction of its capital * * * if the effect of such distribution will be to reduce the actual value of its assets to an amount less than the total amount of its debts and liabilities plus the amount, as reduced, of its capital."

shall not have been otherwise provided for and said certificate shall so state.

Such reduction of the capital of the corporation may be effected by retiring or reducing the outstanding shares of any class or by drawing the necessary number of outstanding shares of any class by lot for retirement, or by the exchange by the holders of outstanding shares of any class of the shares of such class held by them for a decreased number of shares of stock of the same or of a different class of stock, or by the exchange of shares having par value for shares having no par value, or of shares without par value for shares with par value, or by the exchange of shares having par value for an increased number of shares of lesser par value, or by the exchange of par value shares for shares without par value and/or par value shares of any class, or by the exchange of shares without par value for par value shares and/or shares without par value of any class, the effect of which is to work a reduction of capital, or by reducing (in conjunction with appropriate action under Section 26 of this Chapter) the par value of the shares of any class of stock having par value, or where the amount of capital represented by shares of stock having par value exceeds such par value, by reducing the amount of capital represented by such shares by an amount not greater than such excess, or by reducing the amount of capital represented by shares of stock having no par value, or, in case the capital shall have been increased by the transfer thereto from surplus pursuant to the provisions of Section 14 of this Chapter and the transfer shall not have been made in respect of any designated class or classes of stock, by retransferring to surplus all or any part of the amount by which capital shall have been so increased, or by the purchase of shares for retirement, either pro rata from all holders of shares of that class of stock or by purchasing such shares from time to time in the open market or at private sale in both cases at not exceeding such price or prices as may be fixed or approved by the stockholders entitled to vote upon the reduction of capital to be effected in that manner, or by retiring shares owned by the corporation. If such reduction of capital of the corporation be effected by retiring shares, then, if the consent or resolution of stockholders above referred to shall so provide, an amount not exceeding that part of the capital of the corporation represented by such shares may be charged against or paid out of the capital of the corporation in respect of such shares.

If such reduction of capital shall have been effected by retiring or reducing the outstanding shares of any class in any of the manners above mentioned, including the retirement of shares already owned by the corporation, the shares so retired or by the acquisition of which in any manner the outstanding shares of such class shall have been reduced shall, upon the filing and recording of the certificate as provided in this Section, if the Certificate of Incorporation does not prohibit the reissue thereof, have the status of authorized and unissued shares of the class of stock to which such shares belong. If the Certificate of Incorporation prohibits the reissue of such shares the filing and recording of such certificate, containing a recital of such fact, shall constitute an amendment to the Certificate of Incorporation effecting a reduction of the authorized capital stock of the corporation to

the extent of the aggregate par value of such shares, or, if such shares are without par value, to the extent of the total number of such shares. If such shares constitute all the outstanding shares of any particular class and the reissue thereof is so prohibited, the filing and recording of such certificate, containing a recital of such fact, shall constitute an amendment to the Certificate of Incorporation effecting a reduction in the authorized capital stock of the corporation by the elimination therefrom of all reference to said particular class of stock.

When any corporation shall decrease the amount of its capital as hereinbefore provided, the above-mentioned certificate shall be published for three weeks successively at least once in each week, in a newspaper published in the county in which the principal office of the corporation is located; the first publication to be made within fifteen days after the filing of such certificate, and in default thereof the directors of the corporation shall be jointly and severally liable to any creditors of the corporation who shall suffer loss by reason of the noncompliance with the provisions of this section and the stockholders shall be similarly liable up to the amount of such sums as they may respectively receive of the amount so reduced; provided that no such decrease of capital shall release the liability of any stockholder, whose shares have not been fully paid, for debts of the corporation theretofore contracted.

REDUCTION OF CAPITAL

It has been observed above (page 207ff.) that corporations are obliged to set up a figure on an estimated "capital" on their balance sheet; and that originally this was the aggregate par value of the issued shares having par value, and now it is calculated according to a statutory formula. It has further been noted that corporations are accorded the power to repurchase certain kinds of shares, especially preferred shares, with their assets and write down the item as "capital" by an amount equal to the "capital represented by" such preferred shares, also in accordance with statutory formula. This is the principal practical use of "reduction of capital". Clearly, if all the stock had to be retired out of surplus, the surplus fund might become so reduced that payment of dividends was impossible. A businessman will argue that if he paid off a note, he would reduce the assets side of his balance sheet by the amount paid; and he would likewise reduce his liability side by the face of the note. Why, he argues, can I not do the same thing when I buy in and cancel a share of stock? When he is told that he can do that—by reducing the item called "surplus" he points out that surplus is an all-purpose item capable of being used for dividends, repurchase of stock, etc; whereas "capital" is restricted. It gives him greater freedom therefore to reduce the capital item, leaving the surplus for further operations. Anyway, he argues, preferred stock is merely a weaker substitute for a credit instrument. He has been successful in these arguments.

But, in respect to common stock, the situation is not so clear. Repurchasing a share of common stock, with intent to cancel it, is very much like buying out one of the partners. If the capital "represented

by" the common stock is paid out, there is no particular reason to assume that it will come back. There is also no reason to assume that it is being paid out merely because the corporation has no further need for the money. It is, in fact, a partial distribution of the corporate assets to one of the group, leaving the remaining members to stand the risks of not sharing the profits of the business. Carried to its extreme, and if there were no restrictions, reduction of capital by this route might leave the business without substantial capital, but with debts and other obligations for which no provision was made.

Accordingly, provisions permitting reduction of capital restrict the use of this power. Thus, under no circumstances can capital be reduced or paid out to shareholders if as a result the corporation is made insolvent. This is rather illusory as protection; theoretically, a corporation with a million dollars debts could reduce its capital to $1.00 provided its total assets remained $1,000,000. A creditor would not consider that it was "protected" by this arrangement; lenders and businessmen do not grant credit unless the borrower has a substantial margin over and above the amount of the debt.

Quite commonly, reduction of capital, occasioned by retiring common stock, is not permitted if the remaining capital is reduced below the amount "represented by" the preferred stock.

The theory is that a corporation should not be permitted to pay out the capital junior to its senior obligations (preferred stock, debts) unless

(a) sufficient assets remain within the corporation to provide for payment of its debts; and

(b) the capital "represented by" the preferred stock is likewise left intact.

In practice probably none of these protections are heavily relied on in the business community. A creditor follows not merely the statutory handling of capital, but also the total balance sheet position of the corporation. If he sees the assets going down, he is pretty apt to insist that his debt be paid. But he may have contracted away any right to insist on repayment of his debt: long-term bond issues, preferred stock issues and so forth do not usually leave it open to holders of the securities to insist on repayment if the capital is dissipated. Surplus, of course, can be distributed as dividends at any time without restrictions. Theoretically, statutes permitting reduction of capital would allow extreme financial mismanagement. Thus, a corporation having $2,000,000. in assets, and $1,000,000. of bonded indebtedness, $500,000. par value preferred stock, and 5,000 shares of non-par common stock would have a balance sheet as follows:

ASSETS: $2,000,000.	LIABILITIES:		
	Bonds		$1,000,000.
	Capital:		
	In respect of Preferred Stock	$500,000.	
	In respect of Common Stock	50,000.	550,000.
	Surplus		450,000.
$2,000,000.			$2,000,000.

The Directors could:

(1) pay out the $450,000 as dividends to the common stock and then dump the common stock, leaving the preferred stock totally unprotected say by a $50,000 margin. This involves no reduction in capital; or

(2) they might pay out the $450,000 as dividends; and retire the preferred stock under a redemption provision for $500,000 leaving $1,050,000 in the corporation against a bonded indebtedness of $1,000,000. Needless to say the bondholders would then be in the position of being full-risk partners in the business—which is not what they expected. Students will think of variations of this theme. Legally, this is possible. Financially, it would be disastrous. Is the power to "reduce capital" subject to any control beyond the statutory requirements, either at the instance of creditors or at the instance of preferred or common stockholders?

BRITISH & AMERICAN TRUSTEE & FINANCE CORPORATION v. COUPER.

House of Lords. [1894] A.C. 399.

The following statement of facts is taken from the judgment of LORD HERSCHELL, L. C.

The appellant company was incorporated in 1890 under the Companies Acts, 1862 to 1886, as a company limited by shares, with a registered office in England.

The capital was £2,000,000 divided into 188,600 ordinary shares of £10 each, and 114,000 general founders' shares of £1 each. The company had issued 63,109 of the shares of £10, on each of which £2 had been paid up, 72,298 of the general founders' shares, all of which were fully paid up. By the articles of association it was provided that the company might reduce its capital by paying off capital. On the 18th of May, 1892, the company presented a petition praying that a special resolution passed and confirmed at extraordinary general meetings of the company might be confirmed by the Court.

The resolution provided for a modification of the conditions of the memorandum of association by a reduction of the capital of the company to £1,691,737, divided into 160,767 ordinary shares of £10 each, and 84,067 general founders' shares of £1 each, and that the remainder of the capital, namely, the 27,833 ordinary shares, numbered as therein mentioned, and the 29,933 general founders' shares, numbered as therein mentioned, be paid off (the capital represented thereby being in excess of the wants of the company), and that such last-mentioned ordinary and general founders' shares respectively and all liability thereon be wholly extinguished.

The company had carried on business in the United States, and a portion of its investments were in that country. These investments had been made on the advice of a committee of the board by the directors resident in America. Differences arose between the board of directors in England and the American committee as to the manage-

ment of the business of the corporation, which rendered it impossible to carry on such business both in England and the United States with advantage. It was accordingly determined that the best course to be adopted was that the company should cease to carry on business in the United States, and it was arranged that the American investments should be made over to the American shareholders, subject to the payment of £11,000 to the corporation, and that the shares held by the American shareholders should be cancelled, thus reducing pro tanto the capital of the company. This arrangement was approved by the shareholders at two extraordinary general meetings. All the creditors of the company were either paid or assented to the arrangement. The interests of the shareholders alone had therefore to be considered. On the hearing of the petition, confirmation by the Court was opposed by one of their number. North J., dismissed the petition with costs, and his decision was affirmed by the Court of appeal (Lindley, Bowen, and A. L. Smith L.JJ.) (1).

LORD MACNAGHTEN: * * *

Under the Companies Act 1862 it was not competent for a company limited by shares to reduce its capital. Such an operation would have been in contravention of one or more of the statutory conditions of the memorandum which the Act as it then stood made unalterable. The difficulty, however, was removed shortly afterwards by legislation. The Companies Act 1867 declares that any company limited by shares may by special resolution so far modify the conditions contained in its memorandum, if authorized so to do by its regulations as originally framed or as altered by special resolution, as to reduce its capital. The power is general. The exercise of the power is fenced round by safeguards which are calculated to protect the interests of creditors, the interests of shareholders, and the interests of the public. Creditors are protected by express provisions. Their consent must be procured or their claims must be satisfied. The public, the shareholders, and every class of shareholders individually and collectively, are protected by the necessary publicity of the proceedings and by the discretion which is entrusted to the Court. Until confirmed by the Court the proposed reduction is not to take effect, though all the creditors have been satisfied. When it is confirmed the memorandum is to be altered in the prescribed manner, and the company as it were makes a new departure. With these safeguards, which certainly are not inconsiderable, the Act apparently leaves the company to determine the extent, the mode, and the incidence of the reduction, and the application or disposition of any capital moneys which the proposed reduction may set free. * * *

Turning to the facts of the case under appeal, your Lordships have before you an English company limited by shares, and formed for the purpose of engaging in financial undertakings of every sort and description in every part of the globe. Its main purpose, however, was to make investments in English and American securities; and its operations so far have been confined to that field. The English business is under the control of the board of directors in London. The American business has been managed by some of the directors who are resident

in America acting as a committee, under the supervisions of the London board. For some time past there has been friction between the London board and the American committee. The board were cautious and old-fashioned. The committee advocated a bolder policy, and demanded a freer hand. Matters were approaching a deadlock; at last, after much negotiation, both sides arrived at the conclusion that a separation of interests was desirable. It was seen that, in the state of the market, winding-up would be disastrous to all concerned; so it was proposed that the American shareholders, who were content to follow the American committee, should take over the American assets, and sever their connection with the company, and that the English shareholders should take the English assets, receiving an agreed sum by way of adjustment. The proposed arrangement has been approved by special resolution at general meetings, in which the American shareholders apparently took no part. The application to the Court was for an order confirming a reduction of capital to meet the arrangement. It is for the company and for the company alone, to judge of the prudence of the course proposed. The objects of the company are wide enough to employ or exhaust the wealth of Lombard Street or the City of London. But, again, it is for the company to determine, subject, of course, to the statutory provisions for the protection of creditors, whether its capital under the circumstances, and in view of the policy approved by the shareholders, is or is not in excess of its present wants. It is not suggested by the one shareholder who stands alone in opposing the application that the majority are acting oppressively, or that the arrangement is unfair or inequitable in the ordinary sense of those words. His real objection rather seems to be that he prefers the American system of doing business, and that he has more confidence in the American committee than in the London board. * * *

Undoubtedly, as Lindley, L.J., observes, "the cases upon reduction of capital are not in a satisfactory state." There are authorities in which it seems to be laid down that a proposed reduction of capital cannot be confirmed if it involves a purchase by the company of its own shares, and for that reason alone. That of itself, however, cannot be a sufficient objection. The shares are not to be purchased out of the company's capital, but out of moneys withdrawn from the capital and set free by the reduction. A company cannot employ any part of the capital with which it is registered, so long as it forms part of its capital, in the purchase of its own shares. But if it proposes to reduce its capital in accordance with the statutory provisions which empower it to do so, there is no reason why it should not employ the fund set free by the reduction in the purchase of shares which it is intended to extinguish. Nothing can be more contrary to the principle of the Companies Acts than the return of capital by a company limited by shares. But if capital money is set free by reduction of capital, no one ever suggested that it could not be returned to the shareholders, and indeed the Act of 1877 declares that such an operation is included in the power conferred by the Act of 1867. The fact that a thing is prohibited if it is done in the wrong way, and at a time when the circumstances of the case do not justify it, is no reason for holding the thing

prohibited if it is to be done in the right way and when it is justified by circumstances.

Mr. Romer, who argued the case very well, did not press this point as constituting in itself a sufficient answer to the application. The reduction he said was not objectionable simply because it involved a purchase by the company of its own shares, but because a purchase by a company limited by shares of some of its own shares must involve dealing with shareholders, members of one and the same class, in different ways. You cannot, he said, reduce or extinguish all the others of the same class. That was the objection which in the opinion of the Court of Appeal would have been fatal to the application of the Denver Hotel Company if the Court had regarded the transaction as really a purchase of shares. The words of sect. 3 of the Act of 1877 "cannot in our opinion," said Lindley, L.J., "be construed so as to enable a company to prefer one shareholder to another of the same class as himself by buying up his shares." With all deference I venture to think that mode of stating the proposition is really begging the question. It assumes that the person whose shares are to be purchased is getting a preference—an undue advantage for himself at the expense of his fellow shareholders. But why should that assumption be made? The person whose shares are bought gets money or money's worth. The person on whose behalf the company buys have their own shares improved by the value of the shares extinguished. If the parties to the transaction come to the conclusion that the bargain is a fair one, why should the Court say that there is a preference on the one side or on the other? If there is nothing unfair or inequitable in the transaction, I cannot see that there is any objection to allowing a company limited by shares to extinguish some of its shares without dealing in the same manner with all other shares of the same class. There may be no real inequality in the treatment of a class of shareholders although they are not all paid in the same coin or in coin of the same denomination. * * *

In the result, therefore, I am of opinion that the objection on the part of the respondent is not well founded. I think the proposed reduction is within the powers conferred by the Act of 1867. "There is nothing in the Act," as North, J., has observed in the case of The Barrow Haematite Steel Company (4), "which requires that the reduction should be spread either equally or rateably over all the shares in the company." There is nothing, in my opinion, unfair or inequitable in the arrangement involved in the proposed reduction, and I see no reason why it should not be confirmed. * * *

Order appealed from reversed, and the special resolution confirmed; the appellant company to be allowed hereafter to discontinue the use of the word "Reduced;" Cause remitted to the Chancery Division.

PAGE v. AMERICAN & BRITISH MANUFACTURING CO.

Supreme Court of New York, Appellate Division, First Department, 1908.
129 App.Div. 346, 113 N.Y.S. 734.

Appeal by plaintiff, Ostinelli F. Page, from a judgment of the Supreme Court in favor of defendant, American & British Mfg. Co., after a trial at New York Special Term, sustaining defendant's demurrer to the complaint.

LAUGHLIN, J. The demurrer was interposed by the manufacturing company, defendant, and is upon the ground that the complaint fails to state facts sufficient to constitute a cause of action. The point presented for decision is whether a domestic business corporation organized with preferred and common stock, each class of stock having the same voting power, may reduce one class of stock against the will of a holder of some of that class of stock, and thereby reduce his voting power and voice in the management of the affairs of the corporation. The defendant manufacturing company was organized on the 23d day of May, 1902, under the business corporation law, with a capital of $10,000,000, divided into 100,000 shares of the par value of $100 each. Eighty thousand of these shares were common, and 20,000 preferred, stock. The rights of the holders of preferred and common stock were the same, with the exception that the former were given a prescribed preference in the payment of dividends and in the distribution of the assets. The entire amount of the capital stock was duly issued and is outstanding. The company since its incorporation has been engaged in the business for which it was organized. On the 24th day of January, 1908, one Charles R. Flint assigned 10 certificates for 100 shares each of the common stock of the company, which were duly issued to him on the 15th day of January, 1903, to the plaintiff who thereupon became entitled to surrender such shares and have other shares issued in his name in order that he might be a stockholder of record. The company and the other defendant, its stock transfer agent, declined to accept a surrender of the shares or to issue new certificates to the plaintiff on due tender and demand therefor. This refusal was evidently made upon the ground that the common stock had been reduced, for it is alleged that at a meeting of the stockholders, the validity of which is questioned and it is unnecessary to decide, held on the 12th day of April, 1907, by a majority vote the capital stock was reduced from $10,000,000 to $2,000,000 consisting of 20,000 shares of common of the par value of $1,000,000 and 20,000 shares of preferred of the par value of $1,000,000. The stock, which was assigned to the plaintiff was not voted on at the meeting but 330 shares of preferred stock and 843 shares of common stock were voted on in opposition to the resolution. The effect of the action taken is to give the holders of the preferred stock, who only contributed one-fifth of the capital, an equal vote and voice in the management of the corporation with the holders of the common stock who contributed four-fifths of the capital, and it reduced the voting power and authority of the stock owned by the plaintiff four-fifths without any reduction

in the voting power or authority of the preferred stock. We are of opinion that this action was clearly illegal, both on principle and under the recent decision in Stokes v. Continental Trust Company, 186 N.Y. 285, 78 N.E. 1090, 12 L.R.A.,N.S., 969.

The capital stock of a corporation may be increased or reduced as authorized by statute; but, in the absence of express statutory provision, the right of the individual stockholder to the proportionate voice in the conduct of the affairs of the corporation and equitable interest in its property which his stock gives him when he becomes a stockholder must be preserved. The interest of the plaintiff in the property, if dissolution were to take place now, might not be affected by the action taken because on dissolution the preferred stock was first to be paid in full; but the right of a stockholder to a voice in the management of a corporation in which he has invested money is a property right and vested interest entitled to protection under the Constitution. Kinnan v. Sullivan County Club, 26 App.Div. 213, 50 N.Y.S. 95; Lord v. Equitable Life, 47 Misc. 187, 94 N.Y.S. 65, affirmed 109 App.Div. 252, 96 N.Y.S. 10; Smith v. A., T. & S. F. R. R. Co., C. C., 64 F. 272; People v. Hawkins, 157 N.Y. 1, 51 N.E. 257, 42 L.R.A. 490, 68 Am.St.Rep. 736. Of course, it would be competent for the Legislature to provide that, as to corporations to be organized in the future, either the common or the preferred stock might be separately reduced, and no vested right of a stockholder becoming such in the light of a statutory provision to that effect would be impaired by such reduction. Section 44 of the stock corporation law[3] (Laws 1890, p. 1074, c. 564), however, which is the authority for increasing or reducing the capital stock, prescribes only in general terms for such reduction or increase, and that authority must be exercised in such manner that the rights of stockholders will be preserved. If the stock be increased, it was held in the Stokes Case that each stockholder must be afforded an opportunity to purchase the same proportionate interest therein as he held prior thereto. It must follow that, if the stock be reduced, a reduction must be upon lines which will leave each stockholder the same proportionate interest and right in the corporation as he had before the reduction. If, therefore, the capital stock be divided into preferred and common stock, there must be a reduction of both in the proportion that the issue of each bears to the other. It may be that there can be no reduction of preferred stock. If so, there can be no reduction as to common stock without unanimous consent, and in such case the general authority to reduce capital stock should be held not to be applicable.

Of course, as already observed, it would have been competent for the Legislature to have prescribed otherwise; but mere general authority for an increase or reduction of capital stock is not sufficient. The plaintiff succeeded to the rights of Flint. He brings the action to compel the corporation and its transfer agent to accept a surrender of his stock and to issue to him new stock which will enable him to enjoy all of the rights and privileges of a stockholder of record. On

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[3] Cf. N.Y.Stock Corporation Law, § 36, supra, p. 1329.

the facts pleaded and admitted by the demurrer, he appears to be entitled to this relief.

It follows that the judgment should be reversed with costs and the demurrer overruled, with costs, with leave to the demurrant to plead over on payment of costs of the appeal and of the demurrer. All concur.

JAY RONALD COMPANY, INCORPORATED v. MARSHALL MORTGAGE CORPORATION et al.

Court of Appeals of New York, 1943. 291 N.Y. 227, 52 N.E.2d 108.

Submission of a controversy pursuant to sections 546–548 of the Civil Practice Act by Jay Ronald Company, Inc., suing on behalf of itself and all other stockholders of the Marshall Mortgage Corporation similarly situated, against Marshall Mortgage Corporation and others for distribution of capital surplus. From an adverse judgment, 265 App.Div. 622, 40 N.Y.S.2d 391, defendant Marshall Mortgage Corporation appeals, and plaintiff Jay Ronald Company, Inc., files a cross-appeal.

Reversed and judgment directed for defendant; cross-appeal dismissed.

LOUGHRAN, JUDGE. This controversy was submitted to the Appellate Division upon agreed facts pursuant to Civil Practice Act, sections 546–548.

The defendants are a domestic corporation and its officers and directors. The corporate defendant was organized in 1926 with a stated capital of $300,000 represented by 100,000 common shares of no par value. Since April, 1938, a varying number of these shares have been in the ownership of the plaintiff.

At a meeting of the stockholders held on January 22, 1940, the stated capital of the corporate defendant was reduced from $300,000 to $100,000 and the resulting capital surplus of $200,000 was transferred to a surplus account "for all purposes for which a surplus may be used." When this corporate action was taken the assets of the corporate defendant were of an actual value in excess of $300,000 over and above its liabilities, exclusive of its liability on its capital stock. A certificate of such capital reduction was filed with the Secretary of State on January 31, 1940. These corporate proceedings were taken without participation by the plaintiff as a stockholder of the corporate defendant.

The Appellate Division has granted to the plaintiff a judgment which reads in part as follows: "The capital surplus of $200,000 created by the reduction in capital of the defendant corporation may not be retained by the defendant corporation as a corporate surplus, or for any other purpose, but said capital surplus shall be distributed in cash, without interest, among the persons who were stockholders of record * * * at the close of business on January 31, 1940, pro rata according to their then respective shares." As appellant here, the corporate defendant centers its attack upon this direction of the plaintiff's judgment.

Plaintiff maintains and the Appellate Division has held that a true surplus resulting from a reduction of corporate capital is at once owed by the corporation as a debt to its stockholders in accordance with their respective interests. So it was laid down in Seeley v. New York National Exchange Bank, 8 Daly 400, affirmed on opinion below 78 N.Y. 608. The reasons for that decision were precisely given. It was said by the court of first instance: "The abandonment by a corporation of all its corporate rights gives the stockholders a right to the distribution of all the net assets. Why should not an abandonment of a portion of those rights give the stockholders a right of distribution pro tanto? * * * That [surplus] money was paid as capital, and if it be no longer needed for that purpose, and if it be not required for the payment of debts, it has accomplished the end for which it was subscribed, and it ought to be returned to the shareholders. * * * If the retired capital be a liability of the corporation in favor of the shareholders who give up the stock that is called in, the payment of that debt cannot lie in any man's discretion." (8 Daly at page 403.)

The Seeley case was not decided under any New York statute. Our State courts there dealt with Federal legislation permitting national banks to reduce capital. No provision for disposition of surplus had been made therein. We first inquire, then, whether the reasoning of the Seeley case is compatible with the applicable New York statutes regulating reduction of the capital of stock corporations.

The decision of the Seeley case was made by this court in 1879. The first New York statute that made provision for the disposition of surplus resulting from reduction of corporate capital was chapter 306 of the Laws of 1882. The provision then made was that "the amount of capital left in the possession of the company over and above the amount to which the capital shall be so reduced shall be returned to the stockholders pro rata at such times and in such manner as the trustees or directors shall determine." We think this express allowance to directors of discretion to fix the time and manner of the return of such a surplus can hardly be reconciled with the rigid ideas on which the decision of the Seeley case was made to turn.

The statute so enacted in 1882 remained substantially unchanged until 1901. The text of chapter 354 of the Laws of that year was in part as follows: "Any domestic corporation may increase or reduce its capital stock in the manner herein provided * * *." (§ 44.) "Every such increase or reduction must be authorized either by the unanimous consent of the stockholders, expressed in writing and filed in the office of the secretary of state and in the office of the clerk of the county in which the principal business office of the corporation is located, or by a vote of the stockholders owning at least a majority of the stock of the corporation, taken at a meeting of the stockholders specially called for that purpose in the manner provided by law or by the by-laws." (§ 45.) "If the capital stock is reduced, the amount of capital over and above the amount of the reduced capital shall, *if the meeting or consents so determine or provide,* be returned to the stockholders pro rata, at such times and in such manner as the directors shall determine." (§ 46. The emphasis is ours.) This unqual-

ified license to the stockholders to say whether or no there should be any distribution of such a surplus seems to us to have been a pretty complete negation of the rule of the Seeley case.

So the law stood until 1923. All provisions respecting disposition of surplus resulting from reduction of corporate capital were left out of the Stock Corporation Law, Consol.Laws, c. 59, § 1 et seq., as it was then recast by chapter 787 of the Laws of that year, with the result that the stockholders were no longer authorized to say whether such a surplus should be returned. But this omission, as we see it, affords no reason for saying that a distribution of every such surplus thereupon became compulsory upon the directors of the corporation. So belated a reversal of policy would scarcely have been conceivable in the face of the new comprehension of corporate structure that in 1912 had led to the introduction of no par shares. See Vaughan v. State of New York, 272 N.Y. 102, 5 N.E.2d 53, 108 A.L.R. 950.

At this point it is in order to answer the claim of an absence prior to 1929 of any statutory provision respecting disposition of retired capital of no par corporations. Section 23 of chapter 351 of the Laws of 1912 said that for the purpose of any statutory provision relating to the amount of the capital stock of a corporation or the amount or par value of its shares, the aggregate amount of the capital stock of a no par corporation was in general to be deemed to be the aggregate amount of its capital. Thus, as we think, any general statutory provision regulating reductions of par stock was made applicable to reductions of no par stock,—for there was no reason at all why reductions of no par stock should result differently from reductions of par stock.

Section 8 of chapter 441 of the Laws of 1924 re-established the capacity of the stockholders having par value shares to say "that the excess over the amount to which the capital stock is reduced shall be returned *in whole or in part* to the stockholders pro rata, at such times and in such manner as the directors shall determine". (The accentuated words were new.) In the main, this enactment restored the law to what it had been from 1901 to 1923; then by section 4 of chapter 652 of the Laws of 1929, the stockholders of no par value corporations were explicitly licensed to compel a return on a reduction of capital.

The present proceedings to reduce the capital of this defendant corporation were taken under section 36(15) of the Stock Corporation Law, Consol.Laws, c. 59, as amended by chapter 334 of the Laws of 1939. It was thereby enacted that "the certificate [of the stockholders] shall provide that the surplus, if any, resulting from such reduction shall be available for any one or more of the following purposes: (a) to be used for any purpose for which surplus may be used; or (b) to be reserved and used for specified purposes; or (c) to be returned to the stockholders, according to their respective rights, at the times and in the manner specified."

We have now canvassed the statutory provisions which seem to us to control the present controversy. Our conclusion is that from the year 1901 to the present time no distribution of a surplus created by reduction of capital of a stock corporation has been required by the law of New York except when pursuant to statute the stockholders so de-

creed. In that view, the 1939 statute last above indicated was in essence a declaration of what had been the law from a time long antecedently to the organization of the corporate defendant in 1926. It follows that the 1939 statute was here applicable and sanctioned the disposition of the surplus in question as made by the stockholders of the corporate defendant.

There are expressions in Strong v. Brooklyn Crosstown R. Co., 93 N.Y. 426 and in Roberts v. Roberts-Wicks Co., 184 N.Y. 257, 77 N.E. 13, 3 L.R.A.,N.S., 1034, friendly to the Seeley case, supra. But the question now decided was not presented in the Strong case or in the Roberts case and we have felt free to dispose of it as an open matter.

The judgment so far as appealed from by the corporate defendant, should be reversed, and judgment directed for that defendant as prayed for in the submission, without costs. The cross-appeal of the plaintiff from denial of its demand for interest and counsel fees and for directions as to distribution of the surplus in question is now futile and should be dismissed, without costs.

Judgment accordingly.

NOTE

"If a corporation finds its capital either impaired or excessive, it may well be for the best interests of all shareholders to reduce the amount of outstanding stock. * * * This may be analyzed as being a matter of accounting adjustment which enables the corporation thereafter to show a surplus rather than a deficit in the balance sheet. The real, proportionate interest of each shareholder in the assets of the corporation is not affected thereby; nor will there be an appreciable effect on the market price through the reduction in par value. Again, where a corporation finds under changed conditions, that its working capital is too large for its present scope of operation, resort profitably may be made * * * to reduce the authorized or outstanding capital stock. If all stockholders are affected, the result is a partial return of the original investment to each one; if not, it amounts to a complete or a partial return of the investment with a lessened interest in the remaining assets on the part of those who are paid." Jones, Redeemable Corporate Securities, 1931, 5 So.Calif.L.Rev. 83, 85. See, also, Ballantine, A Critical Survey of the Illinois Business Corporation Act, 1934, 1 U. of Chi.L.Rev. 357, 374–378; Hills, Model Corporation Act, 1935, 48 Harv.L.Rev. 1334, 1376–1377; Warren, Safe-Guarding the Creditors of Corporations, 1923, 36 Harv.L.Rev. 509, 533–538; Notes, 1934, 19 Corn.L.Q. 470; 1934, 47 Harv.L.Rev. 693; 1935, 21 Va.L.Rev. 562; 1937, 36 Mich.L.Rev. 96.

Where a corporation, under a plan of recapitalization, issues new prior preferred stock and reduces its capital, the reduction has been held to be such a material alteration of preferential rights as to entitle a dissenting preferred stockholder to appraisal of his shares. "The reduction in capital constitutes a material alteration of the preferential rights of the old preferred for it has reduced materially and finally the amount of stated capital which theretofore had safeguarded the preferential rights of the old preferred stock." Matter of Kinney, 279 N.Y. 423, 431, 18 N.E.2d 645, 1939; 39 Col.L.Rev. 1037, 52 Harv.L.Rev. 1011; *accord*, Matter of Gohn v. Peoples Collateral Loan Corp., 174 Misc. 188, 20 N.Y.S.2d 254, 1940. See, also, Dean, A Review of the Law of Corporate Reorganizations, 1941, 26 Corn.L.Q. 537, 569–574.

New York Stock Corporation Law, § 58: "* * * nor shall any (stock) corporation * * * make any distribution of assets to any of its stockholders * * * upon a reduction * * * of its capital, unless the value of its assets remaining

after * * * such distribution of assets, * * * shall be at least equal to the aggregate amount of its debts and liabilities, including capital. * * *"

Where capital stock is impaired and a reduction is made to meet that impairment, there must not be a distribution to stockholders. But where this is not the case, the surplus realized from a reduction of capital belongs to the stockholders of record at the time of the reduction. Jerome v. Cogswell, 204 U.S. 1, 27 S.Ct. 241, 51 L.Ed. 343, 1906.

"The surplus, if any, which a corporation reducing the amount of its capital * * * is at liberty to pay to its stockholders, must, in every case, be ascertained, and depends upon the result of an examination into its affairs, and not upon the difference between the original amount of capital and the reduced amount, and whenever, by sales of property, or by means of earnings, or otherwise, the corporation comes in possession of funds which are in excess of the reduced amount as fixed capital, it can distribute that excess without violating any law." Strong v. The Brooklyn Cross-Town Railroad Company, 93 N.Y. 426, 435, 1883. See, also, Note, Reduction of Capital Stock and Distribution of Capital Assets upon Reduction, 1926, 44 A.L.R. 11.

Where a dividend declaration impairs capital, a subsequent capital stock reduction which sets up a surplus over and above all indebtedness, will save the directors from liability. Greene v. Boardman, 143 Misc. 201, 256 N.Y.S. 340, 1932, aff'd without opinion, 240 App.Div. 745, 265 N.Y.S. 965, 1st Dep't., 1933.

PART III

PUBLIC ISSUE OF STOCK

A. PURPOSE AND SCOPE OF THE SECURITIES ACT OF 1933

NOTE

The Securities Act of 1933 was passed to correct some of the abuses that had arisen in the distribution of securities. * * * All persons seeking to use the mails or means of interstate commerce for the disposition of securities must file a registration statement with the Commission. A prospectus based on the registration statement must be given to the investor prior to any offer of sale. The Act authorizes the Commission to adopt rules and regulations governing registration statements and prospectuses for various classes of securities and issuers. These rules and regulations prescribe the form or forms in which the required information shall be set forth, and methods to be followed in the preparation of financial statements and reports or valuations by experts. The information required to be furnished in these documents is guided by Schedule A of the Act, which sets forth the type of disclosure envisaged by Congress. MacChesney and O'Brien, Full Disclosure Under the Securities Act, 1937, 4 Law & Contemp. Problems 133.

The Securities Act * * * affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering. It carefully exempts from its application certain types of securities and securities transactions where there is no practical need for its application or where the public benefits are too remote. Report of Committee on Interstate and Foreign Commerce.[1]

1. THE SECURITIES ACT OF 1933

FRAUDULENT INTERSTATE TRANSACTIONS

Sec. 17. (a) It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement,

[1] For discussions of the Securities Act, see: Chamberlain, The Securities Act of 1933, 1933, 19 A.B.A.J. 643; Douglas and Bates, The Federal Securities Act of 1933, 1933, 43 Yale L.J. 171; Feldman, The New Federal Securities Act, 1934, 14 B.U.L. Rev. 1; Hanna and Turlington, The Securities Act of 1933, 1933, 28 Ill.L.Rev. 482; James, The Securities Act of 1933, 1934, 32 Mich.L.Rev. 624; Three Years of the Securities Act, 1937, 4 Law & Contemp.Problems 1-270; Note, 1933, 33 Col.L.Rev. 1220; Note, 1933, 31 Mich.L.Rev. 1117.

newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 3 shall not apply to the provisions of this section. Securities Act of 1933, 15 U.S.C.A. § 77q.

NOTE

Section 17(a) of the Securities Act of 1933 makes unlawful the use of any misrepresentations or fraudulent schemes in the sale of securities. A very considerable part of the Commission's litigation involves injunctive actions to restrain violations of this section. For example, in Securities and Exchange Commission v. Timetrust, Inc., 39 F.Supp. 145 (D.C.N.D.Calif.1941), an injunction was obtained where representations were made that Timetrust certificates were similar to a savings account, whereas the solicitation to purchase such certificates was merely a device for selling Bank of America stock on the instalment plan.[2] In S.E.C. v. Investors Syndicate (D.Minn.1943), an injunction was obtained where representations were made that the certificates sold were better or safer than United States War Bonds, that the purchase of such certificates was a patriotic duty and aided the war effort, that the yield was higher than War Bonds, and that the certificates were guaranteed by the United States or the Securities and Exchange Commission. (Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934–1944, p. 8.)

CIVIL LIABILITIES ARISING IN CONNECTION WITH PROSPECTUSES AND COMMUNICATIONS

Sec. 12. Any person who—

(1) sells a security in violation of section 5, or

(2) sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security. Securities Act of 1933, 15 U.S.C.A. § 77e.

PROHIBITIONS RELATING TO INTERSTATE COMMERCE AND THE MAILS

Sec. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

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[2] On appeal, the Ninth Circuit Court on July 31, 1942, remanded the case to the trial court for specific findings of fact as to whether or not the defendants devised a fraudulent scheme within the prohibitions of the statute. On October 24, 1942, the trial court returned its additional findings of fact in which it found that all of the defendants employed Timetrust as a device, scheme and artifice to defraud. The Circuit Court on May 8, 1944, affirmed the judgment as to Timetrust, Inc., Parker, Wood and Blanchett, and reversed the judgment as to Bank of America, A. P. Giannini and L. Mario Giannini.

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security registered under this title, unless such prospectus meets the requirements of section 10; or

(2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of section 10. Securities Act of 1933, 15 U.S.C.A. § 77c.

2. WHAT CONSTITUTES A SECURITY

DEFINITIONS

Sec. 2. When used in this title, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. * * * Securities Act of 1933, 15 U.S.C.A. § 77b.

SECURITIES AND EXCHANGE COMMISSION v. CRUDE OIL CORPORATION OF AMERICA et al.

Circuit Court of Appeals of the United States, Seventh Circuit, 1937.
93 F.2d 844.

The plaintiff brought this suit to enjoin the defendants from selling securities in violation of section 5 of the Securities Act, as amended, 15 U.S.C.A. § 77e. The defendants denied: violations of the Securities Act; their engagements in interstate commerce; the constitutionality of the applicable sections of the Securities Act. They assailed the constitutionality of the act; denied that a "security" is an article of commerce that may be the subject of regulation by Congress; and challenged the court's finding that they made false and fraudulent representations with intent to deceive in the sale of their contracts.

At the close of the trial on the merits the court made findings and conclusions the essence of which is here briefly stated:

The Crude Oil Corporation of America is a Delaware corporation known as the "Corporation"; principal place of business is Tulsa, Oklahoma. B. E. Buckman & Company is a Wisconsin corporation; home office is at Madison. Wells-Kendall Company is a Delaware cor-

poration with its principal place at Madison. The business of the Corporation is transacted as follows:

It purchases oil royalties commonly called "farmers' oil" of an estimated oil content of one and one-half times as great as the aggregate number of barrels called for in the delivery contracts here involved. It pays for the royalties at the rate of 25 cents a barrel of the estimated content. The farmer or owner who leases his property to a producer to market the oil removed therefrom ordinarily receives one-eighth of the proceeds of the oil produced on his property. It is a part of this one-eighth interest that the corporation purchases in the form of a royalty. These royalties are transferred to one W. C. Franklin as trustee under a trust agreement. Franklin is a director and treasurer of the corporation, also its attorney. The corporation then, through its salesmen in Wisconsin and other states, enters into delivery contracts with residents of said states. The purchaser signs an application in the following form:

"I hereby make application to purchase ——— barrels of crude oil of ——— gravity at $——— per barrel, to be deliverable in accordance with the terms and conditions set forth in your ———.

"Draft for $——— is handed you herewith, representing payment in full."

He receives a so-called bill of sale, material parts of which are:

"Crude Oil Corporation of America
"Tulsa, Oklahoma

"Bill of Sale and Delivery Contract for ——— Barrels of Crude Oil

"Crude Oil Corporation of America, the seller, has sold to and agrees to deliver, and ——— of ——— has purchased at the price of $——— per barrel, ——— barrels of crude oil of ——— Baume gravity, payment for which is hereby acknowledged by the seller.

"It is intended hereby that actual delivery of such oil is to be made to the buyer and the seller agrees to deliver the number of barrels of oil purchased by the buyer.

"The sale and delivery of such oil is made subject to the following terms and conditions:

"(1) The seller shall deliver to the buyer such oil in monthly quantities but not less than ——— barrels during any one year until the fulfillment of this agreement, * * *

"(2) The buyer shall notify the seller when he desires delivery of such oil, but until the buyer shall call for delivery of oil to him, and to provide the tankage therefor, the seller shall not be required to segregate the buyer's oil, and it is hereby authorized to sell the buyer's deliverable oil to any oil purchasing or pipe line company at the posted price at the time of sale, and shall remit the net proceeds thereof to the buyer without deduction of any kind whatsoever except such state and federal taxes as may be imposed thereon. The oil so sold shall be regarded as delivery of oil to the buyer under the terms of this agreement.

"(3) * * *

"Crude Oil Corporation of America
"By ———
"President

"Attest:
" ———
"Secretary."

At the time of signing the application purchaser pays to the Corporation salesman the sum of 50 cents (now 57 cents) for each barrel of oil specified in the application. The salesman mails the check or draft received as payment and copies of the application to the Corporation at Tulsa, Oklahoma. The Corporation mails, either to its salesmen or to the purchasers, delivery contracts in the form mentioned, together with a so-called Trust Certificate. Approximately 275 of these contracts, covering nearly 1,000,000 barrels of oil, have been entered into between the Corporation and the buyers. The average number of barrels of oil mentioned in each contract is 3000, although some of the contracts specify amounts less than 500 barrels.

Franklin, the trustee, receives from those operating the pipe lines, out of the proceeds of oil runs to the pipe lines, the royalty interests the Corporation owns, and he deposits these remittances in a special account. Checks for sums indicating that the delivery contracts are being fulfilled at a rate of approximately 4% of the whole each year are drawn against this account each month in favor of the purchasers and sent through the mails from Tulsa, Oklahoma, to the purchasers.

The Corporation may fulfill the contract over a period of twenty-five years, and has that length of time to perform its contract with the buyer. *The contracts are not made with persons who contemplate taking actual delivery of the oil* in the Texas field, rather than the proceeds derived from the sale of the oil. The contracts make such procedure impracticable and highly unprofitable to the buyer. The Corporation has been operating since 1934. It has made contracts with over 275 buyers specifying approximately 1,000,000 barrels of oil, *and to date no buyer has asked for delivery of oil at the place of production.*

On August 15, 1935, the Corporation entered into an agreement with the Wells-Kendall Company whereby the Wells-Kendall Company arranged for the employment of B. E. Buckman & Company to act as the agent for the Corporation in the procuring of the said delivery contracts. B. E. Buckman & Company was accordingly employed by the Corporation as its salesman in this territory and procured for it approximately 250 delivery contracts specifying, on an average, 3000 barrels of oil in each contract. For this service it received a commission of 7½ cents for each barrel of oil specified in the contracts. The Wells-Kendall Company received for its service rendered to the Corporation as aforesaid, 2½ cents for each barrel of oil specified in the said contracts obtained by B. E. Buckman & Company.

The defendant Corporation since 1935 has made use of the United States Mail and of instruments of transportation and communication in interstate commerce in the making and execution of said contracts.

It has used the mails to transport and deliver the said applications, the bill of sale and delivery contracts, trust agreements, trust certificates, checks and vouchers, prospectuses and advertising literature. The prospectuses are attached to the Bill of Complaint. One of the prospectuses carried a reproduction of a letter apparently received by the Corporation from a satisfied customer. It failed to state that this letter was written by a person who had also acted as its sales agent in procuring the bill of sale and delivery contracts.

The Corporation does not buy and sell crude oil in large and small quantities. It has but one marketing method, namely, that of buying oil royalties and the making of the delivery contracts. The purchaser under the delivery contract does not and cannot determine the amount of oil to be sold each month under his agreement with the Corporation.

The defendants, Crude Oil Corporation of America and B. E. Buckman & Company, have and are using the mails and instruments in interstate commerce in the making and execution of the said contracts.

No registration statement has been filed with the Securities & Exchange Commission.

The royalties conveyed to Franklin as trustee, subsequent to the execution of the delivery contracts, have been paid for out of the proceeds the Corporation has received from the purchasers of the delivery contracts. The operating expenses of the Corporation, including the commission paid its salesmen, are also paid out of these receipts.

A decree was entered in favor of the plaintiff, from which the defendants have prosecuted this appeal.

EVANS, Circuit Judge (after stating the facts as above). While numerous legal propositions are raised and argued in the briefs, there are only two vital and determinative questions before us. (a) Is the instrument denominated a "bill of sale and delivery contract" a "security" or "investment contract," as these terms are used in the Securities Act, or did defendants' contract evidence the sale of a commodity? (b) Is section 5(a) of the Securities Act, 15 U.S.C.A. § 77e(a), a valid exercise of legislative power as applied to defendants' transactions with their customers?

(a) Was the bill of sale and delivery contract a "security" or an "investment contract" as these terms are used in the Securities Act?

Section 77b(1), Title 15 U.S.C.A. reads as follows:

"The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

In view of its purpose we can not construe this section narrowly.[3] The Congress evidently intended to include all interstate transactions which were the legitimate subject of its regulation of sale of securities. Such has been the uniform holding of courts that have construed the act.

The legislation in question followed the enactment of what has generally been called the Blue Sky Laws of the various states, and the ingenuity and fertility of resources of those dealers in securities who deliberately attempted to avoid their application supplied the background of experience against which this legislation was written.

While there are many decisions which involve somewhat kindred transactions and define the contracts as "securities," there is one, other than that of the court below, which dealt with a contract almost similar to the one under consideration. In Securities and Exchange Commission v. Aldrich Blake, Inc., et al., decided by the Supreme Court of the District of Columbia, May 19, 1936, such a contract was held to be a "security." Similar holdings on quite similar contracts wherein avoidance of the state Blue Sky Laws was sought, appear in State v. Ogden, 154 Minn. 425, 191 N.W. 916; People v. McCalla, 63 Cal.App. 783, 220 P. 436.

Contracts of widely varying content which have been held under the state Blue Sky Laws to be "securities" are:

Sale of royalty interests in proceeds of oil wells—O'Connell v. Union Drilling & Petroleum Co., 121 Cal.App. 302, 8 P.2d 867.

Unit in an association operating oil enterprise—Barrett v. Gore, 88 Cal.App. 372, 263 P. 564.

Rabbit contract—Gracchi v. Friedlander, 93 Cal.App. 770, 270 P. 235.

Deed evidencing interest in oil wells—Barnhill v. Young, D.C., 46 F.2d 804.

Contract for interest in oil well proceeds—Black v. Solano Co., 114 Cal.App. 170, 299 P. 843.

Fractional interest in oil lease—People v. Craven, Cal.App., 21 P.2d 459; Western Oil & Refining Co. v. Venago Oil Corp., 218 Cal. 733, 24 P.2d 971, 88 A.L.R. 1271.

Memorandum contracts covering interest in mining profits—People v. Reese, 136 Cal.App. 657, 29 P.2d 450.

Agreement to give share in profits from metallurgical discovery—State of Minn. v. Code, 178 Minn. 492, 227 N.W. 652.

Sale of interest in invention—State v. Swenson, 172 Minn. 277, 215 N.W. 177, 54 A.L.R. 490.

Unit holders of leasehold of oil lands held investment contracts—State v. Ogden, 154 Minn. 425, 191 N.W. 916.

Units of oil syndicate—State v. Summerland, 150 Minn. 266, 185 N.W. 255.

Development of vineyard contracts—Kerst v. Nelson, 171 Minn. 191, 213 N.W. 904, 54 A.L.R. 495.

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[3] Securities & Exchange Commission v. Wickham, D.C., 12 F.Supp. 245; Kerst v. Nelson, 171 Minn. 191, 213 N.W. 904, 54 A.L.R. 495; Note in 87 A.L.R. 42, 61. (Footnote by the Court.)

If we look to the acts of the parties which accompanied and followed the execution of these contracts and ascertain the true intention of the contracting parties therefrom, strong confirmation of the conclusion which the District Court reached, appears.

Called a "Bill of sale and delivery contract" it recited in the first paragraph a sale of a designated number of barrels of oil, and there is found therein the express provision, "it is intended that actual delivery of such oil is to be made."

If this paragraph were the only provision of the agreement, it would clearly be a bill of sale and evidence the sale of a commodity. It was not, however, all of the contract. The statement "It is intended that actual delivery of such oil is to be made" was false. Far more significant and controlling than the recital is the fact that there was never a single barrel of oil delivered.

As a deed absolute on its face may nevertheless be a mortgage which secures a loan, so here, the denominated bill of sale was by its own terms a contract which was something quite different from a bill of sale. The provisions which appeared in subparagraphs (1) and (2) negative and in fact nullify that provision of the agreement requiring delivery of the oil, which provision appeared in a preceding paragraph. In effect we have a contract where the parties expressly and specifically agree that they are buying and selling oil and that the oil sold is to be delivered by the seller and received by the buyer, followed by provisions in the same agreement which in effect say that the said foregoing agreement shall be ineffectual and the seller is not to deliver the oil to the buyer, but is to sell the same. The buyer is not to receive the oil, but is to accept the proceeds of the sales, which proceeds are to be paid monthly and distributed over a maximum period of twenty-five years. Not only do we find provisions to this effect, but the uniform action of the parties bespeaks their intentions.

The speculative feature of the transaction, the lure held out by the seller, was to be found in the possible rise in the price of oil during this twenty-five year period. The language of the prospectus makes this perfectly clear:

"The fact that the known world supply of crude is sufficient for only a short span of years, that a tremendous amount of research work has not recently resulted in the finding of any new major pools leads those in position to know, to believe that crude oil will sell in the near future for prices far above to-day's figures.

"Every one desiring a given monthly income should investigate the regular monthly profit possibilities available through the ownership and sale each month of a given number of barrels of crude oil. Should investigate the simplicity of the purchasing and marketing arrangement available through this corporation and the possibilities of exceptional profits to be made as prices for crude oil advance."

By placing the acts and deeds of the parties against their professions of innocence and good faith, we are better able to reach the correct conclusion.

The burdens imposed upon the so-called purchaser by the contracts in question prevented him from acquiring possession of any oil. It is

fair to say that actual delivery of the oil was not only not intended, but was impossible. The purchaser was required to give thirty days' notice before the month during which he desired to exercise his so-called right of delivery. He was required to go to the point of production and provide for the storage of oil in the East Texas oil field and to furnish tankage facilities for the unknown quantity of oil he was to receive. The gallon quantity of this oil was determined solely by the corporation, and no notice to the purchaser of the amount he was to receive in any month was required. The purchaser might be required to furnish a five gallon tank or a thousand gallon receptacle. To construe this contract as a contemplated sale of oil requires us to picture a Wisconsin purchaser making the journey to Texas to secure a monthly quota of oil which would be so small (as small as three barrels) that the cost of obtaining it would be grossly disproportionate to any possible profit. Further reasons for the conclusions reached by the District Court and approved by us require no elaboration.

The title of the contract, to-wit, "Bill of Sale and Delivery Contract," was a misnomer and a deceptive one. It was obviously conceived for the purpose of avoiding any regulatory control by state or Federal governments of a "security" speculative in nature. The seller hoped and intended to deceive the said Boards thereby, and this accounts for the false recital in the forepart of the agreement.

Without further discussion we state our conclusion which is that the District Court correctly held the document was a "security" and not a sale of a commodity and fell within the language of the above-quoted section of the Securities Act.

(b) Is section 5(a) of the Securities Act of 1933, 15 U.S.C.A. § 77e(a), as amended, valid when applied to defendants' transactions?

Section 5(a) is as follows:

"Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale."

The court found and it is not denied that there was no registration with the Securities Commission. * * *

Confining our attention to the narrower and more precise question, namely, the power of Congress to enact section 5 of the 1933 Securities Act, as amended, 15 U.S.C.A. § 77e, we are satisfied it is a valid exercise of the power by Congress.

Reaching this conclusion we adopt the following from Judge Manton's opinion in Electric Bond and Share Co. v. Securities and Exchange Commission, 2 Cir., 92 F.2d 580, 587:

"Nor is the police power within the field of interstate commerce limited to prohibiting the transportation of articles that are themselves harmful. The stolen motor-car involved in the Brooks Case, 267 U.S. 432, 45 S.Ct. 345, 69 L.Ed. 699, 37 A.L.R. 1407, was not in

itself different from an automobile lawfully acquired. There was nothing harmful or immoral about prison-made goods, governed by the Hawes-Cooper Act, 49 U.S.C.A. § 60, involved in Whitfield v. Ohio, 297 U.S. 431, 56 S.Ct. 532, 80 L.Ed. 778, supra, or in the oil regulated by the Connally Act, 15 U.S.C.A. § 715 et seq., Griswold v. President, etc., 82 F.2d 922, C.C.A.5. In each of these statutes, as in the registration provisions of this Act, it was held, Congress conditioned particular uses of the channels of interstate commerce upon certain safeguards to prevent those uses from being made the instruments of causing evil or harm in a state other than the state of origin, even though the articles or communications transported might not be inherently harmful. The use of the channels of interstate commerce, regulated by Congress, has been an essentially business or commercial use. The courts have never regarded the innocence or harmfulness of the mere physical movement of persons, goods, or communications as determinative of the limits of Congressional power, so long as the activities regulated were genuinely honest in character. The Securities Act of 1933 and the Securities Exchange Act of 1934, 15 U.S.C.A. § 77a et seq. and § 78a et seq., make it unlawful to use the mails or channels of interstate commerce without complying with regulations prescribed by the Commission in respect of certain transactions in securities. We held this a valid exercise of Congressional power. Jones v. Securities and Exchange Comm., 79 F.2d 617, C.C.A.2, reversed in 298 U.S. 1, 56 S.Ct. 654, 80 L.Ed. 1015, on other grounds; Coplin v. United States, 88 F.2d 652, C.C.A.9; Securities and Exchange Comm. v. Torr, 15 F.Supp. 315, D.C.S.D.N.Y., reversed 87 F.2d 446, C.C.A.2, on other grounds."

The decree is affirmed.[4]

SECURITIES AND EXCHANGE COMMISSION v. W. J. HOWEY COMPANY et al.

Supreme Court of the United States, 1946. 328 U.S. 293, 66 S.Ct. 1100.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

Suit by the Securities and Exchange Commission against W. J. Howey Company and Howey-in-the-Hills Service, Inc., to restrain alleged violations of the Securities Act. To review a judgment of the Circuit Court of Appeals, 151 F.2d 714, affirming a judgment of the District Court, 60 F.Supp. 440, for defendants, plaintiff brings certiorari.

Reversed.

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case involves the application of § 2(1) of the Securities Act of 1933 to an offering of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor.

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[4] 1940, 28 Calif.L.Rev. 410.

The Securities and Exchange Commission instituted this action to restrain the respondents from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered and non-exempt securities in violation of § 5(a) of the Act, 15 U.S.C.A. § 77e (a). The District Court denied the injunction, 60 F.Supp. 440, and the Fifth Circuit Court of Appeals affirmed the judgment, 151 F.2d 714. We granted certiorari, 327 U.S. 773, 66 S.Ct. 821, on a petition alleging that the ruling of the Circuit Court of Appeals conflicted with other federal and state decisions and that it introduced a novel and unwarranted test under the statute which the Commission regarded as administratively impractical.

Most of the facts are stipulated. The respondents, W. J. Howey Company and Howey-in-the-Hills Service, Inc., are Florida corporations under direct common control and management. The Howey Company owns large tracts of citrus acreage in Lake County, Florida. During the past several years it has planted about 500 acres annually, keeping half of the groves itself and offering the other half to the public "to help us finance additional development." Howey-in-the-Hills Service, Inc., is a service company engaged in cultivating and developing many of these groves, including the harvesting and marketing of the crops.

Each prospective customer is offered both a land sales contract and a service contract, after having been told that it is not feasible to invest in a grove unless service arrangements are made. While the purchaser is free to make arrangements with other service companies, the superiority of Howey-in-the-Hills Service, Inc., is stressed. Indeed, 85% of the acreage sold during the 3-year period ending May 31, 1943, was covered by service contracts with Howey-in-the-Hills Service, Inc.

The land sales contract with the Howey Company provides for a uniform purchase price per acre or fraction thereof, varying in amount only in accordance with the number of years the particular plot has been planted with citrus trees. Upon full payment of the purchase price the land is conveyed to the purchaser by warranty deed. Purchases are usually made in narrow strips of land arranged so that an acre consists of a row of 48 trees. During the period between February 1, 1941, and May 31, 1943, 31 of the 42 persons making purchases bought less than 5 acres each. The average holding of these 31 persons was 1.33 acres and sales of as little as 0.65, 0.7 and 0.73 of an acre were made. These tracts are not separately fenced and the sole indication of several ownership is found in small land marks intelligible only through a plat book record.

The service contract, generally of a 10-year duration without option of cancellation, gives Howey-in-the-Hills Service, Inc., a leasehold interest and "full and complete" possession of the acreage. For a specified fee plus the cost of labor and materials, the company is given full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops. The company is well established in the citrus business and maintains a large force of skilled personnel and a great deal of equipment, including 75 tractors, sprayer wag-

ons, fertilizer trucks and the like. Without the consent of the company, the land owner or purchaser has no right of entry to market the crop;[5] thus there is ordinarily no right to specific fruit. The company is accountable only for an allocation of the net profits based upon a check made at the time of picking. All the produce is pooled by the respondent companies, which do business under their own names.

The purchasers for the most part are non-residents of Florida. They are predominantly business and professional people who lack the knowledge, skill and equipment necessary for the care and cultivation of citrus trees. They are attracted by the expectation of substantial profits. It was represented, for example, that profits during the 1943-1944 season amounted to 20% and that even greater profits might be expected during the 1944-1945 season, although only a 10% annual return was to be expected over a 10-year period. Many of these purchasers are patrons of a resort hotel owned and operated by the Howey Company in a scenic section adjacent to the groves. The hotel's advertising mentions the fine groves in the vicinity and the attention of the patrons is drawn to the groves as they are being escorted about the surrounding countryside. They are told that the groves are for sale; if they indicate an interest in the matter they are then given a sales talk.

It is admitted that the mails and instrumentalities of interstate commerce are used in the sale of the land and service contracts and that no registration statement or letter of notification has ever been filed with the Commission in accordance with the Securities Act of 1933 and the rules and regulations thereunder.

Section 2(1) of the Act defines the term "security" to include the commonly known documents traded for speculation or investment. This definition also includes "securities" of a more variable character, designated by such descriptive terms as "certificate of interest or participation in any profit-sharing agreement," "investment contract" and "in general, any interest or instrument commonly known as a 'security.'" The legal issue in this case turns upon a determination of whether, under the circumstances, the land sales contract, the warranty deed and the service contract together constitute an "investment contract" within the meaning of § 2(1). An affirmative answer brings into operation the registration requirements of § 5(a), unless the security is granted an exemption under § 3(b), 15 U.S.C.A. § 77c(b). The lower courts, in reaching a negative answer to this problem, treated the contracts and deeds as separate transactions involving no more than an ordinary real estate sale and an agreement by the seller to manage the property for the buyer.

The term "investment contract" is undefined by the Securities Act or by relevant legislative reports. But the term was common in many state "blue sky" laws in existence prior to the adoption of the federal statute and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to

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[5] Some investors visited their particular plots annually, making suggestions as to care and cultivation, but without any legal rights in the matters.

afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic realty. An investment contract thus came to mean a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938. This definition was uniformly applied by state courts to a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves.

By including an investment contract within the scope of § 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims. In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Such a definition necessarily underlies this Court's decision in Securities Exch. Commission v. C. M. Joiner Leasing Corp., 320 U.S. 344, 64 S.Ct. 120, 88 L.Ed. 88, and has been enunciated and applied many times by lower federal courts. It permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of "the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.Rep.No.85, 73rd Cong., 1st Sess., p. 11. It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.

The transactions in this case clearly involve investment contracts as so defined. The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third

parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments. Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. The resulting transfer of rights in land is purely incidental.

Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed. The investment contracts in this instance take the form of land sales contracts, warranty deeds and service contracts which respondents offer to prospective investors. And respondents' failure to abide by the statutory and administrative rules in making such offerings, even though the failure result from a bona fide mistake as to the law, cannot be sanctioned under the Act.

This conclusion is unaffected by the fact that some purchasers choose not to accept the full offer of an investment contract by declining to enter into a service contract with the respondents. The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities.[6] Hence it is enough that the respondents merely offer the essential ingredients of an investment contract.

We reject the suggestion of the Circuit Court of Appeals, 151 F.2d at page 717, that an investment contract is necessarily missing where the enterprise is not speculative or promotional in character and where the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole. The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value. See S. E. C. v. C. M. Joiner Leasing Corp., supra, 320 U.S. 352, 64 S.Ct. 124, 88 L.Ed. 88. The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae.

Reversed.

MR. JUSTICE JACKSON took no part in the consideration or decision of this case.

MR. JUSTICE FRANKFURTER dissenting.

"Investment contract" is not a term of art; it is a conception dependent upon the circumstances of a particular situation. If this case came before us on a finding authorized by Congress that the facts disclosed an "investment contract" within the general scope of § 2(1)

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[6] The registration requirements of § 5 refer to sales of securities. Section 2(3) defines "sale" to include every "attempt or offer to dispose of, or solicitation of an offer to buy," a security for value.

of the Securities Act, 48 Stat. 74, 15 U.S.C. § 77b(1), 15 U.S.C.A. § 77b(1), the Securities and Exchange Commission's finding would govern, unless, on the record, it was wholly unsupported. But that is not the case before us. Here the ascertainment of the existence of an "investment contract" had to be made independently by the District Court and it found against its existence. 60 F.Supp. 440. The Circuit Court of Appeals for the Fifth Circuit sustained that finding. 151 F.2d 714. If respect is to be paid to the wise rule of judicial administration under which this Court does not upset concurrent findings of two lower courts in the ascertainment of facts and the relevant inferences to be drawn from them, this case clearly calls for its application. See Allen v. Trust Co. of Georgia, 326 U.S. 630, 66 S.Ct. 389. For the crucial issue in this case turns on whether the contracts for the land and the contracts for the management of the property were in reality separate agreements or merely parts of a single transaction. It is clear from its opinion that the District Court was warranted in its conclusion that the record does not establish the existence of an investment contract:

"* * * the record in this case shows that not a single sale of citrus grove property was made by the Howey Company during the period involved in this suit, except to purchasers who actually inspected the property before purchasing the same. The record further discloses that no purchaser is required to engage the Service Company to care for his property and that of the fifty-one purchasers acquiring property during this period, only forty-two entered into contracts with the Service Company for the care of the property." 60 F.Supp. at page 442.

Simply because other arrangements may have the appearances of this transaction but are employed as an evasion of the Securities Act does not mean that the present contracts were evasive. I find nothing in the Securities Act to indicate that Congress meant to bring every innocent transaction within the scope of the Act simply because a perversion of them is covered by the Act.

NOTE

(A) A sale by a broker of unregistered instruments called "mineral right deeds in fee" which purported to grant to the holders "the entire interest in oil and gas" in certain undivided acres, and which instruments were subject to a collateral agreement whereby profits were prorated among all the owners of the undivided interests, was held to be a sufficient basis to deny the broker a registration since these instruments constituted "fractional undivided interests in oil, gas, or other mineral rights". However, even if this were not so, "it would nevertheless be a security within the meaning of the Act because it is an 'investment contract' and represents a 'participation in a profit-sharing agreement' ". In the Matter of Franklyn J. V. Stowitts, 6 S.E.C. 97, 1939.

A "receipt" for oil "when, as and if produced" was held to be a "security" as defined in Section 2(1). Securities and Exchange Commission v. Aldrich Blake, Inc., Sup.Ct. of D.C., May 19, 1936; C.C.H. Securities Act Service, ¶ 1610.015.

(B) Pursuant to a "conditional bill of sale", D agreed to deliver five barrels of oyster half-shells to certain docks in Florida, or in lieu thereof, at the buyer's option, to plant the shells on one acre of oyster bottom which the buyer should lease from the State of Florida. The court looked through the form to the substance

of the scheme and found that this was in fact an "investment contract" within Section 2(1) of the Securities Act of 1933. Securities and Exchange Commission v. Cultivated Oyster Farms Corp., U.S.Dist.Ct., So.Dist. of Fla., Mar. 22, 1939; III C.C.H.Fed.Sec.Law Serv. ¶ 90,103.

(C) A "prosperity" plan whereby one dollar certificates were redeemed by D Co. when they were affixed with fifty-five two-cent D Co. stamps, the surplus going to persons designated by the original purchasers of the certificates was enjoined on the ground that these certificates constituted securities, that D Co. was not a charitable institution as alleged in its by-laws, and that the securities had not been registered with the Securities and Exchange Commission. Securities and Exchange Commission v. United Prosperity Plan, Inc., U.S.Dist.Ct., Dist. of Utah Cent.Div., Oct. 9, 1937; III C.C.H.Fed.Sec. Law Serv., ¶ 90,115.

(D) Where depositors contributed to a fund to establish a University of Plenocracy which, among other things, was to carry out agricultural operations and return to the "supporters of the faith of Plenocracy" 30% profit per annum, it was held that the certificates constituted "securities" within Section 2(1) of the Securities Act of 1933. The arguments that the "application" moved from the "investor" to the defendants and that the depositors were merely making a voluntary donation to a charitable use were rejected on the ground that the court would examine the set-up to discover the actual relationship existing between issuer and investor. Securities and Exchange Commission v. Universal Service Ass'n, 106 F.2d 232, C.C.A. Ill.1939, cert. den. 308 U.S. 622, 60 S.Ct. 378, 84 L.Ed. 519, 1940.

(E) It must be remembered that in enforcing either the fraud or disclosure provisions, it is necessary that a sale of a security be involved. Not only is the Commission presented with instances of flagrant disregard of the statute in the sale of ordinary securities without compliance with the statute, but more subtle efforts have been made to evade such provisions. Sales of securities have been disguised and camouflaged so as to appear to be simple sales of real or personal property. The scheme usually adopted is to execute to the investor what appears to be an ordinary bill of sale. Coupled with this is an oral or written understanding that the property sold is to remain in the possession and control of the promoter who is to distribute the profits to the purchaser. In S.E.C. v. Payne, 35 F.Supp. 873 (D.C.S.D.N.Y. 1940), the security was disguised as a purported sale of silver foxes. In S.E.C. v. Cultivated Oyster Farms, 1 S.E.C. Jud.Dec. 672 (S.D.Fla., 1939), it was oyster bottom acreage. In S.E.C. v. Tung Corporation, 32 F.Supp. 371 (D.C.N.D.Ill.1940), and S.E.C. v. Bailey, 41 F.Supp. 647 (D.C.S.D.Fla. 1941), it was interests in tracts for the development of tung trees. Other cases of the same nature were S.E.C. v. Pyne, 33 F.Supp. 988 (D.C.Mass.1940), shares in fishing boats; S.E.C. v. Bourbon Sales Corp., 47 F.Supp. 70 (D.C.W.D.Ky., 1942), whiskey bottling contracts; S.E.C. v. Universal Service Corp., 106 F.2d 232 (C.C.A.7, 1939) cert. den., 308 U.S. 622, 60 S.Ct. 378 (1940), contributions to a scientific crop growing enterprise; S.E.C. v. Crude Oil Corporation, 93 F.2d 844 (C.C.A.7, 1937) crude oil; S.E.C. v. Joiner, 320 U.S. 344, 64 S.Ct. 120 (1943), oil and gas leases; S.E.C. v. City Meter Service (D.N.J., 1939) and S.E.C. v. Parking Meter Corp. (N.D.Ohio, 1939), parking meters; S.E.C. v. Sentenal (S.D.Ohio, 1941), popcorn machines; S.E.C. v. Gilbert, 29 F.Supp. 654 (D.C.S.D.Ohio, 1939), shares in cargo boats; S.E.C. v. George Washington Cemetery (D.N.J.1942), cemetery lots; S.E.C. v. Monjar (D.Mass.1942), "personal loans". Such efforts to evade the statute are due usually to the inherent unsoundness of the securities sold. In the case of the sale of tung tree land, for instance, it was shown that the acreage being sold was not suitable for such production.

The Commission, of course, does not take the position that an ordinary sale of real or personal property involves the sale of a security. But where a purchaser has no intention of assuming any control of the property purchased, but is really buying only an interest in a business enterprise and looks solely to the efforts of the pro-

moter to earn a profit for him, the courts have sustained the Commission's position that the substance controls the form and that there is involved the sale of a security and in the use of misrepresentations and fraudulent schemes an injunction should be issued. (Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934–1944, p. 10.)

3. WHAT CONSTITUTES A SALE

(3) The term "sale", "sell", "offer to sell", or "offer for sale" shall include every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value; except that such terms shall not include preliminary negotiations or agreements between an issuer and any underwriter. Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been sold for value. The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be a sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security. Securities Act of 1933, 15 U.S.C.A. § 77b(3).

S.E.C. RULES AS TO THE USE OF FORM E—1[7] (Note to Rule 5)

The Commission deems no sales to stockholders of a corporation to be involved, within the meaning of the definition quoted in Rule 5 (2), where, pursuant to statutory provisions or provisions contained in the certificate of incorporation, there is submitted to the vote of such stockholders a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of securities of such other person, or a plan or agreement for a statutory merger or consolidation, provided the vote of a required favorable majority

(a) will operate, so far as the corporation the stockholders of which are voting is concerned, to authorize the transfer or to effectuate the merger or consolidation (except for the taking of action by the directors of the corporations involved and for compliance with such statutory provisions as the filing of such plan or agreement with the appropriate state authorities), and

(b) will bind all stockholders of such corporation, except to the extent that dissenting stockholders may, under statutory provisions or provisions contained in the certificate of incorporation, be entitled to receive the appraised or fair value of their holdings.

The Commission deems it immaterial in these circumstances whether the person the securities of which are to be issued is in existence or not; whether, if such person [is] in existence, the plan, agreement or proposal is submitted by or with its authority; or whether, in the case of transfer of assets, such securities are to be issued to stockholders directly, or are to be distributed to them as a liquidating dividend or otherwise.

When, in accordance with this Note, submission of a plan, agreement, or proposal to the vote of stockholders involves no sale to them, the Commission deems no sales to be involved in the delivery of securities to such stockholders.

Accordingly, neither the submission to the vote of stockholders of a plan, agreement or proposal of the character specified in this Note, nor the delivery of se-

[7] Form E-1 was revoked and was replaced by Form S-1, April 1, 1947. Consequently the above note is now useful only as an expression of policy, still in effect under § 2(3) of the Act, 15 U.S.C.A. § 77b(3).

curities thereunder to such stockholders, requires the registration of such securities or the delivery of a prospectus meeting the requirements of Section 10 of the Act. * * *

NOTE

In several cases the courts have defined the statutory term sale of a security to include the stamping by a company of securities previously issued by it with a legend reciting an agreement of the holders to an extension of maturity (S.E.C. v. Associated Gas & Electric Co., 24 F.Supp. 899, D.C.S.D.N.Y., 1938), the solicitation of subscribers to an investment advisory service to sign statements that they would or "may" accept stock in a corporation not yet in existence (S.E.C. v. Starmont, 31 F.Supp. 264, D.C.E.D.Wash., 1939), and an exchange of property for stock (U. S. v. Riedel, 126 F.2d 81, C.C.A. 7, 1942). In U. S. v. Kopald-Quinn & Co., 1 S.E.C. Jud.Dec. 371 (N.D.Ga., 1937), a dealer's confirmation slips were held part of the securities transactions and the final step in their sale for the purpose of determining whether the mails were used in the sale of a security. In National Supply Co. v. Leland Stanford Junior University, 134 F.2d 689 (C.C.A.9, 1943), the Commission's interpretative rule excluding from the definition of a sale the issuance in a statutory merger or consolidation of new securities exclusively to the security holders of the constituent corporations was upheld. (Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934–1944, p. 10.)

4. EXEMPTED SECURITIES AND TRANSACTIONS

NOTE

The exemptive provisions of the Act may be classified as:

First: Provisions exempting securities by reason of the character of the issuer.[8]

Second: Provisions exempting securities by reason of the character of the security or the issue of which the security is a part, regardless of the character of the issuer.[9]

Third: Provisions exempting securities by reason of the manner of their distribution, regardless of the character of the issuer, the security, or the issue of which it is a part.[10]

Fourth: Provisions exempting particular classes of transactions, regardless of the character of the issuer, the security, the issue of which the security is a part, or the manner in which the security was originally distributed.[11] Throop and Lane, Some Problems of Exemption Under the Securities Act of 1933, 1937, 4 Law and Contemporary Problems 89, 91.

Most securities or transactions "exempted" by the Securities Act are not entirely freed from the requirements imposed by that statute. The express exemptions enumerated in Sections 3 and 4, 15 U.S.C.A. §§ 77c, 77d, except for transactions in the securities of the federal and state governments, their instrumentalities, and banking institutions, are "exemptions" only insofar as the registration and prospectus provisions are concerned. Thus the civil liabilities of Section 12, 15 U.S.C.A. § 77*l*, apply to a security "* * * whether or not exempted by the provisions of section 3 * * *", and the provisions of Section 17, 15 U.S.C.A. § q, are also expressly applicable to transactions otherwise exempt by Section 3. Finally, a brief prospectus or schedule sheet is required as to some of the exemptions adopted pursuant to Section 3(b).

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8 Sections 3(a) (2) and 3(a) (4) to 3(a) (8), inclusive. [Securities Act of 1933, 15 U.S.C.A. § 77c(a) (2, 4, 8)].

9 Section 3(a) (3) and exemptions adopted under Section 3(b), 15 U.S.C.A. § 77c(a) (3), (b).

10 Sections 3(a) (9), 3(a) (10), 3(a) (11), 15 U.S.C.A. § 77c(a) (9–11), and Sections 77 and 77B of the Bankruptcy Act, 11 U.S.C.A. §§ 205, 207 Note: 77B is now Chapter X, 11 U.S.C.A. § 501 et seq.).

11 Sections 3(a) (1), 4(1), and 4(2), 15 U.S.C.A. §§ 77c(a) (1), 77d(1, 2).

(a) Securities

EXEMPTED SECURITIES

Sec. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

(1) Any security which, prior to or within sixty days after the enactment of this title, has been sold or disposed of by the issuer or bona fide offered to the public, but this exemption shall not apply to any new offering of any such security by an issuer or underwriter subsequent to such sixty days;

(2) Any security issued or guaranteed by the United States or any Territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States, or any certificate of deposit for any of the foregoing, or any security issued or guaranteed by any national bank, or by any banking institution organized under the laws of any State or Territory or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or Territorial banking commission or similar official; or any security issued by or representing an interest in or a direct obligation of a Federal Reserve Bank;

(3) Any note, draft, bill of exchange, or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited; [12]

(4) Any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual;

(5) Any security issued by a building and loan association, homestead association, savings and loan association, or similar institution, substantially all the business of which is confined to the making of loans to members (but the foregoing exemption shall not apply with respect to any such security where the issuer takes from the total amount paid or deposited by the purchaser, by way of any fee, cash value or other device whatsoever, either upon termination of the investment at maturity or before maturity, an aggregate amount in excess of 3 per centum of the face value of such security), or any security issued by a farmers' cooperative associataion as defined in paragraphs (12), (13), and (14) of section 103 of the Revenue Act of 1932;

(6) Any security issued by a common or contract carrier, the issuance of which is subject to the provisions of section 20a of the Interstate Commerce Act, as amended;

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[12] "In this manner a corporation may obtain funds for current transactions without filing a registration statement for the obligation which it incurs to the lender of the funds. Ordinarily, the latter is a bank or other institution in a favored position to require information about the financial condition of the corporation as a condition precedent to the loan of the funds. Need for control over this kind of situation is not so great as that over the issuance of other kinds of securities. Indeed, regulation of such transactions would be very difficult, and, moreover, would hamper the satisfaction of demands for current funds." Bumiller, Exemptions of Securities and Transactions under Federal Securities Act of 1933, 1936, 10 U. of Cinn.L.Rev. 125, 154.

(7) Certificates issued by a receiver or by a trustee in bankruptcy, with the approval of the court;

(8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

(9) Any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange;[13]

(10) Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval;[14]

(11) Any security which is a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.[15]

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13 See Rule 150.

The exemption is carefully guarded in that no remuneration may be given for the solicitation of the exchange of securities. In the majority of these exchanges, numerous kinds of expenses, as distinguished from commissions or remuneration, are usually incurred. The payment of clerical expenses, legal, accounting or other fees, the cost of engraving new certificates, does not destroy the exemption as the expenses were incurred in the effectuation and not in the promotion or solicitation of the exchange. It is a question of fact in each instance whether a charge is an expense incidental to the exchange, or compensation given for its solicitation. Bumiller, Exemptions of Securities and Transactions under the Federal Securities Act of 1933, 1936, 10 U. of Cinn.L.Rev. 125, 134.

That the exemption of Section 3(a) (9) does not permanently attach to securities which originally fell within its scope, see In the Matter of Thompson Ross Securities Co., 6 S.E.C. 1111, 1118, 1940.

14 See, also, Sections 171–175, Bankruptcy Act, 52 Stat. 840, 1938, 11 U.S.C.A. Sections 571–575; Clark, The Securities and Exchange Commission and the Chandler Act, 1939, 73 U.S.L.Rev. 147; Weiner, The Securities and Exchange Commission and Corporate Reorganization, 1938, 38 Col.L.Rev. 280; Fortas, The Securities Act and Corporate Reorganizations, 1937, 4 Law and Contemporary Problems 218.

15 * * * The legislative history of the Securities Act clearly shows that this exemption was designed to apply only to local financing of such a nature that it may practicably be consummated in its entirety within the single state in which the issuer is both incorporated and doing business. Accordingly, this exemption formerly contained in Section 5(c) of the Securities Act and now reenacted in Section 3(a) (11) of the Act, as amended, is so worded as to be available only to a security "which is a part of an issue sold only to persons resident within" the state in question. In any consideration of the exemption it is essential to appreciate that its application is thus expressly limited to cases in which the *entire issue* of securities is offered and sold exclusively to residents of the state in question.

Moreover, since the exemption is designed to cover only those security distributions which, as a whole, are essentially local in character, it is clear that the phrase "sold only to persons resident", as used in Section 3(a) (11) cannot refer merely to the initial sales by the issuing corporation to its underwriters, or even the subsequent resales by the underwriters to distributing dealers. To give effect to the fundamental purpose of the exemption it is necessary to take the view expressed by the Federal Trade Commission during its administration of the Securities Act, that if the exemption is to be available "it is clearly required that the securities *at the time of completion of ultimate distribution* shall be found only in the hands of investors resident within the state" (Securities Act Release No. 201; italics supplied). This

(b) The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $300,000.[16] Securities Act of 1933, 15 U.S. C.A. § 77c.

SECURITIES AND EXCHANGE COMMISSION v. ASSOCIATED GAS & ELECTRIC CO. et al.

Circuit Court of Appeals of the United States, Second Circuit, 1938.
99 F.2d 795.

AUGUSTUS N. HAND, CIRCUIT JUDGE. The Securities and Exchange Commission brought the above suit against Associated Gas & Electric Company, hereafter called the "company", to restrain it and other defendants from extending the maturity date of certain of its bonds of an issue known as "5½% Convertible Investment Certificates" maturing on November 15, 1938. During the years 1928 and 1929 approximately $31,000,000 at par of the Investment Certificates were issued and sold

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position was adhered to by the Securities and Exchange Commission in its decision in the Brooklyn Manhattan Transit Corporation case, 1 S.E.C. 147, 1935, that an issue of $8,000,000 principal amount of bonds approximately 15% of which, during the course of their distribution were offered and sold to persons resident outside the State of New York could not be exempted under the former Section 5(c) or the present Section 3(a) (11), despite the fact that the issuer, a New York corporation, had in the first instance sold the entire issue to underwriting houses resident in New York State. The bonds could not be considered to have been "sold" until they had reached the hands of purchasers buying for investment and not with a view to further distribution or for purposes of resale.

From these general principles it follows that if during the course of distribution any underwriter, any distributing dealer (whether or not a member of the formal selling or distributing group), or any dealer or other person purchasing securities from a distributing dealer for resale were to sell such securities to a non-resident, the exemption would be defeated. * * * Any such sales to non-residents, however few, and even though legal in themselves would preclude compliance with the conditions of Section 3(a) (11), and would render the exemption unavailable for that portion of the issue sold to residents through use of the mails. * * * Op.Gen. Counsel, Rel. No. 1459, May 29, 1937.

16 On December 9, 1940 the Securities and Exchange Commission made effective an important revision of its rules in connection with the granting of exemptions of security issues not exceeding $100,000 under the Securities Act of 1933. * * * The revision, made under the authority of sections 3(b) and 19(a) rescinded Rules 200 to 210 inclusive under Regulation A, and substituted five new rules, 220 to 224 inclusive.

The emphasis of the new rules is upon expedition and simplification of procedure. Prospectuses are not required in any case, and a domestic issuer need only notify the nearest regional office of its intention to sell. The letter of notification must contain only such information as the names and addresses of issuer, directors and officers, the person or persons for whose benefit the offering is to be made, the purposes for which the net proceeds are to be used, and the principal underwriters, the commission supplies a form letter of notification, but notification at the issuer's option may be by informal letter containing the required information. * * * Note, S.E.C.: Commission Broadens Rules for Exemption of Small Issues, 1941, 26 Corn. L.Q. 343, 343–344. See, also, In the Matter of Brooklyn Manhattan Transit Corp., 1 S.E.C. 147, 1935. See Regulation A, Rules 220–224, 1 C.C.H.Fed.Sec.Law Serv. ¶ 4220, 4221, 4222, 4223, 4224, 1940, 2nd Ed.

or otherwise disposed of. As a result of various reacquisitions and exchanges for other securities, the amount of the certificates outstanding in the hands of the public (exclusive of $144,800 which had been extended under previous proposals) had by January 26, 1938, been reduced to about $3,200,000. In order to conserve cash and to avoid refinancing the securities of a public utility holding company in difficult and uncertain times, the company on January 26, 1938, submitted to the holders of the certificates a proposal to pay off 20% of the principal coming due and to extend the maturity date of the balance either for one year or for five years from the date of maturity at the option of the holder. As an inducement to the holders to extend payment of their certificates for five years an additional interest advance of 2% was offered. Enclosed with the extension offer was a form of letter of transmittal addressed to the company's agent, to be filled out and signed by the holder agreeing to the particular extension elected, with authority to stamp such extension on his certificate. No change in the certificates was proposed other than the extension of the maturity date of the principal that was to remain unpaid, and the interest was to continue at the original rate of 5½% per annum. The extension was to be effected by stamping (by a rubber stamp) a legend on such certificates as were payable to bearer and affixing coupons for the extended period. The form of the legend to be stamped on registered certificates when extended for one year was as follows:

"Twenty per cent (20%) of the principal amount of this Certificate has heretofore been paid. The holder of this Certificate, for value received has agreed to the extension of the maturity of the unpaid portion of the principal hereof to November 15, 1939, to which each successive holder hereof is bound by the acceptance hereof. This Certificate shall continue to bear interest, payable quarterly, upon the unpaid portion of the principal hereof, at the rate of five and one-half per cent (5½%) per annum."

The legend stamped on certificates extended for five years, as well as on those in bearer form, were substantially the same.

At the time of the extension proposed the company was not a registered holding company under the Holding Company Act, 15 U.S.C.A. §§ 79 to 79z—6. It registered as such on March 29, 1938, but continued to make extensions without filing a declaration under Section 7 of the Holding Company Act, 15 U.S.C.A. § 79g, because counsel advised that in their opinion an extension of the maturity did not constitute an issue or sale of a security within the meaning of Section 6(a) of that act, 15 U.S.C.A. § 79f(a), which reads as follows: "Sec. 6 [§ 79f]. (a) Except in accordance with a declaration under section 7 [section 79g] and with the order under such section permitting such declaration to become effective, it shall be unlawful for any registered holding company or subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly (1) to issue or sell any security of such company; or (2) to exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of such company."

The term "issue" is not defined in the act, but in Section 2 (a) (23), 15 U.S.C.A. § 79b (a) (23), the word "sell" is defined thus: " 'Sale' or 'sell' includes any sale, disposition by lease, exchange or pledge, or other disposition."

Judge Clancy held in the court below that the securities evidenced by the stamped certificates delivered to the holders of the old certificates were "sold" within the meaning of Section 6(a) of the Holding Company Act, 15 U.S.C.A. § 79f(a), and made an order restraining the defendants pendente lite from "directly or indirectly extending the maturity date of any of the 5½% Convertible Investment Certificates of the Associated Gas and Electric Company to November 15, 1939, or to November 15, 1943, or to any other date by use of the mails or any means or instrumentality of interstate commerce, except in accordance with a declaration under Section 7 of the Public Utility Holding Company Act of 1935 and with the order under such section permitting such declaration to become effective, as required by Section 6 (a) of such Act." The defendants have appealed from his order. In our opinion it should be affirmed.

If it had been proposed that the old certificates should be surrendered and that new securities having later maturity dates shold be issued in their place it is not questioned that Section 6(a) (1), 15 U.S.C.A. § 79f(a) (1), would apply and a declaration under Section 7, 15 U.S.C.A. § 79g, and an order of the Commission would be necessary to render the new certificates lawful. The effect of the proposal under consideration would be identical. Why a stamp on the old certificates extending their maturity when accepted by the owner would not amount to the issue or sale of a security is hard to see. He would thereby surrender his right to have the certificate paid in full on November 15, 1938, and in place of it would receive 20% in cash and acquire the right to payment of the remaining 80% a year or five years later, instead of upon the original date. There would be a legal consideration for the new obligation and the fact that the same piece of paper would contain the earlier and the later obligation seems quite immaterial. To treat the proposed arrangement as beyond the jurisdiction of the Securities and Exchange Commission would seem to place form above substance and to defeat the statutory purpose of safeguarding the public interest by affording the means of investigating the merits of such transactions by the Commission so that issues of securities may be stopped if found inexpedient for the security-holders.

There may be doubt about whether the security-holder will be as well off if he extends the date of payment and leaves his claim at the risk of the business for one or five years more as he would be if he insisted upon its present liquidation. He is in effect making a further investment and if the general policy of the act is sound he is entitled to have the guidance of the Commission as to its desirability. It is true that some of the risks, such as the priority of certain liens to his claim, may have been settled when he made his original investment but the continuance of it necessarily involves new dangers.

It is argued by the appellants that Section 12(e) of the Holding Company Act, 15 U.S.C.A. § 79*l* (e), gives sufficient supervision over ar-

rangements to extend the maturity of securities without invoking the provisions of Section 6(a) and 7. Section 12(e) reads as follows: "(e) It shall be unlawful for any person to solicit or to permit the use of his or its name to solicit, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, any proxy, power of attorney, consent, or authorization regarding any security of a registered holding company or a subsidiary company thereof in contravention of such rules and regulations or orders as the Commission deems necessary or appropriate in the public interest or for the protection of investors or consumers or to prevent the circumvention of the provisions of this title or the rules, regulations, or orders thereunder."

It is reasonably plain from the text of Section 12(e) that it aims at regulating the solicitation of proxies. The House Committee stated the object of Section 12(e) thus: "Subsection (e) covers the solicitation of proxies in connection with all holding company and subsidiary company securities so that such solicitations will not afford the basis for subtle control adverse to the interests of investors who have a right to be kept fairly and properly informed by representatives of their own choosing." H. R. Rep. No. 1318, 74th Cong., 1st Sess., p. 18.

We do not think it is obvious that Section 12(e) covers the substance of transactions affecting the extension of payment of securities. But if it should apply there would be no conflict between its provisions and those of Section 6(a). If its provisions became applicable through regulations adopted by the Commission to control the solicitation of consents or proxies they would only afford means of protecting security-holders in addition to those embraced in Section 6(a).

It is urged that the interpretation put by the Commission upon Section 12(f) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78*l* (f), as evidenced by Rule JF2 adopted thereunder is inconsistent with the interpretation which it has placed upon Section 6(a) of the Public Utility Holding Company Act of 1935. Rule JF2 continues the unlisted trading privileges of the owners of securities though the maturity, interest rate or amount of principal outstanding has been changed. But the fact that the Commission did not treat extended securities as new issues for the purpose of continuing trading privileges in no way involves the assumption that they should not be regarded as new sales or issues under Section 6(a) and 7 (c) and (d). Continuance of the owner's trading privileges under Section 12 (f) of the Securities Exchange Act, 15 U.S.C.A. § 78*l* (f), affords no reason for depriving him of the protection afforded by Section 6(a) in a case where need of protection is just as great as though the old security had been physically surrendered and a new one issued differing from the former only in maturity date.

In Blue Mountain Consolidated Water Co. v. Public Service Commission, 125 Pa.Super. 1, 189 A. 545, the Pennsylvania Superior Court held that the reduction of the interest rate of a security did not constitute the issuance of a new security but expressly distinguished the reduction of interest from the extension of the maturity date. Whatever might have been the opinion of that court about the effect of an extension we find no justification for disregarding the construction of

Section 6(a) which the Securities and Exchange Commission has adopted. Any interpretation of the meaning of the words "issue or sell" other than the one adopted would involve a tenuous distinction between a new certificate, identical with the old except as to its maturity date, and an old one in which the maturity is extended by an inscription written on the original document. Such a distinction is most unreal and serves to defeat the declared purposes of the act.

The Interstate Commerce Commission has uniformly treated the extension of outstanding obligations as within Section 20a of the Interstate Commerce Act, 49 U.S.C.A. § 20a, and as involving an issue of securities which must have its approval. The long settled practice of that Commission in upholding its jurisdiction over securities, the maturity of which is extended, affords a persuasive analogy in support of the ruling of the Securities and Exchange Commission. Moreover, we are dealing with a new act the administration of which is the peculiar function of the Securities and Exchange Commission. One of the principal reasons for the creation of such a bureau is to secure the benefit of special knowledge acquired through continuous experience in a difficult and complicated field. Its interpretation of the act should control unless plainly erroneous. In no other way can the objects of the act be attained without constant and disconcerting friction. Norwegian Nitrogen Products Co. v. United States, 288 U.S. 294, 315, 53 S.Ct. 350, 77 L.Ed. 796. In view of the foregoing the decision of the court below seems to us to have been plainly correct.

Order affirmed.[17]

IN THE MATTER OF BROOKLYN MANHATTAN TRANSIT CORPORATION.

Securities and Exchange Commission, 1935. 1 S.E.C. 147.

The Brooklyn Manhattan Transit Corporation[18] applied on September 12, 1934, for temporary registration on the New York Stock Exchange of $8,000,000 principal amount of 15-year secured sinking-fund bonds, Series A, due June 1, 1949, and the New York Stock Exchange filed such application with the Commission pursuant to Rule JE1. The Commission, upon the ground that the bonds above referred to were not registered under the Securities Act of 1933, by telegram dated September 26, 1934, notified the company that the application for registration of these bonds on the New York Stock Exchange would be withheld pending a hearing, which hearing was held on October 3 and 4, 1934.

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17 1939, 37 Mich.L.Rev. 1157; 1938, 48 Yale L.J. 149.

18 Brooklyn Manhattan Transit Corporation is a holding company incorporated by and doing business within the State of New York. The company owns all of the capital stock of the New York Rapid Transit Corporation which operates subway and elevated lines in Brooklyn and partly in Manhattan; it controls by majority stock ownership Brooklyn and Queens Transit Corporation operating surface lines in Brooklyn, and through that company owns all the common stock of Brooklyn Bus Corporation which operates bus lines in Brooklyn; and the company owns all of the capital stock of Williamsburg Power Plant Corporation, a business corporation providing power facilities.

Pending this hearing and disposition of this matter, these bonds were removed from active trading on the New York Stock Exchange. Subsequent to the hearing the company, through its counsel, informed the Commission that it intended to register these bonds under the Securities Act of 1933. * * *

On May 9, 1935, the registration statement on Form A-2 was filed for these bonds in accordance with the requirements of the Securities Act of 1933. This statement became effective on May 29, 1935, pursuant to the provisions of the Securities Act of 1933. * * *

The Commission, however, deems it important to review the evidence adduced in the hearing above referred to, and to give its reasons for withholding registration under Section 12 (e) of the Securities Exchange Act of 1934 prior to the filing of a registration statement for these bonds under the Securities Act of 1933.

Inasmuch as the action of the Commission in withholding registration is to be regarded as having been taken pursuant to the provisions of Rule JE7,[19] the primary question that calls for consideration is whether the manner of the issuance and distribution of these bonds was such as to bring them within the traditional and recognized ambit of Federal power, inasmuch as the mails or instruments of transportation and communication in interstate commerce were employed in their distribution, and, that being the case, whether the manner of the issuance of these bonds was such as to grant the issue a specific exemption from registration under Section 5 (c) of the Securities Act of 1933, or Section 3 (a) (11) of the Securities Act of 1933 as amended. The consideration of the question, above stated, involves issues both of law and of fact. Before proceeding to the issues of law involved, it is best to rehearse the manner in which these bonds were issued and distributed as disclosed by the evidence adduced at the hearing.

On or about August 1, 1932, the Brooklyn Manhattan Transit Corporation sold to certain banks through Chase, Harris, Forbes Corporation, Hayden, Stone & Co., and J. & W. Seligman & Co., $13,500,000

[19] Rule JE7. Denial or revocation of temporary registration under Securities Exchange Act of 1934 of securities which are neither registered nor exempted under Securities Act of 1933. If it appears to the Commission, upon complaint or otherwise, that any security for which application for temporary registration on a national securities exchange has been filed with the Commission, or that any security which has obtained temporary registration on a national securities exchange is a security which is neither registered pursuant to the provisions of Section 6 of the Securities Act of 1933, nor exempted pursuant to the provisions of Section 3 of such Act and that transactions in such security by dealers generally or by any particular dealer are not, at the time such facts are alleged before the Commission, exempted pursuant to the provisions of Section 4 of subsection (1) of the Securities Act of 1933, the Commission may, by order and notice to the issuer, direct the issuer to appear at a hearing before the Commission and show cause why temporary registration of such security should not be denied or revoked. If, after such notice and hearing, the Commission finds that the security is neither registered nor exempted pursuant to the provisions of the Securities Act of 1933 and that transactions in such security by dealers generally or by any particular dealer are not, at the time such facts are alleged before the Commission, exempted pursuant to the provisions of Section 4, subsection (1), of the Securities Act of 1933, the Commission may, by order, deny or revoke temporary registration of such security upon any national securities exchange. Upon issuance of notice of hearing to the issuer, in accordance with the foregoing, and pending a final determination of the cause, the Commission may, in its discretion, refuse to grant or may suspend temporary registration of any such security upon any national securities exchange.

Two-Year 6 percent Secured Gold Notes, due August 1, 1934. The company[20] then owed $6,500,000 of bank debt. Pursuant to an agreement or understanding with the bankers, the company suspended dividends on its common stock at the time of the 1932 financing, and agreed to retire the short term debt as promptly as practicable. By April 1934, $6,500,000 of the Two-Year Notes had been retired and at that time the company undertook to retire the Balance of $7,000,000 of notes with the proceeds of the sale of $5,583,000 of the New York Rapid Transit Corporation First and Refunding Mortgage 6 percent Sinking Fund Gold Bonds, due July 1, 1968, augmented by an additional bank loan of $1,500,000. The New York Rapid Transit Corporation Bonds referred to were sold on or about April 18, 1934, to the four banking firms[21] which were the purchasers of the bonds involved in this proceeding. It has been represented that the Rapid Transit bonds were resold by the bankers to a limited number of purchasers. The short term debt of the company was thus eliminated, with the exception of the bank debt, which was thereby increased to $8,000,000.

The $8,000,000 of bonds involved in this proceeding were sold for the purpose of raising funds to liquidate this bank debt of the company. Negotiations commenced in April or early May about the time of the arrangements for the sale of $5,583,000 of New York Rapid Transit Bonds discussed above. Gerhard M. Dahl, Chairman of the Board of Directors, represented the company in the preliminary negotiations with representatives of four banking firms, Hayden, Stone & Co., J. & W. Seligman & Co., Lehman Bros., and Kuhn, Loeb & Co. These firms were, at the time of the negotiations, represented on the board of directors of the Brooklyn Manhattan Transit Corporations by the following men: Charles Hayden, a partner in Hayden, Stone & Co.; Frederick Strauss, a partner in J. & W. Seligman & Co.; Elisha Walker, a partner in Kuhn, Loeb & Co.; and Arthur H. Bunker, a vice president and director of Lehman Corporation, an investment trust managed and controlled by Lehman Bros.

At a regular meeting of the board of directors of the company on May 21, 1934, Dahl reported his discussions with "the bankers" concerning the possibilities of selling an issue of 15-year secured bonds. The directors representing the four interested banking firms withdrew from the meeting. To afford additional time for consideration of the matter, the meeting then adjourned without action to May 23.

Fourteen directors were present at the adjourned meeting of the directors on May 23. The chairman stated that since the regular meeting on May 21 it had been decided, subject to approval by the board, to create an authorized issue of $15,000,000 of Fifteen-Year 6-percent Sinking Funds Bonds, Series A, and to issue and sell at this time $8,-000,000 of such issue. He thereupon submitted to the meeting separate offers of Hayden, Stone & Co., J. & W. Seligman & Co., Lehman Bros., and Kuhn, Loeb & Co., dated May 23, 1934, each to purchase

[20] The Brooklyn Manhattan Transit Corporation is referred to as the company in order to save space and repetition.

[21] Hayden, Stone & Co., J. & W. Seligman & Co., Lehman Bros., and Kuhn, Loeb & Co.

from the corporation, at 95 and accrued interest, $2,000,000 of such bonds. Hayden, Strauss, Bunker, and Walker then withdrew from the meeting, leaving 10 directors present and acting, who after full discussion adopted unanimously a resolution accepting the bids of the bankers.[22]

At a special meeting of the board on June 4, 1934, the directors authorized the creation of the issue of $15,000,000 Secured Bonds described previously and authorized the immediate issuance of $8,000,000 of the bonds.[23] On June 11, 1934, the $8,000,000 of bonds were authenticated and delivered in temporary form. The issuer applied for listing on the New York Stock Exchange on June 30, 1934 and the bonds were listed July 26, 1934.

The four banking firms whose bids for the bonds were accepted by the directors at 2 p. m. on May 23, 1934, resold all the bonds, commencing on a when, as, and if issued basis on May 23, 1934, and concluding their resales on July 17, 1934. The bonds were resold by the banking firms at prices varying from 96½ to 100½, but the major-portion of the issue was sold to the public at 98½.

A series of interrelated circumstances compel the conclusion that the Brooklyn Manhattan Transit Corporation knew, when the transaction occurred, that the four banking firms purchased the bonds with a view to distribution and that such banking firms were acting as "underwriters", within the meaning of Section 2, subsection (11), of the Securities Act of 1933, in connection with the distribution of the issue to the public.

It has been stated that each of the four underwriters was represented on the board of directors of the issuer. In addition, counsel for the banking firms explained in detail to the chief of the Securities Division of the Federal Trade Commission the proposed method of distribution to the public, and the chief of the Securities Division gave his opinion orally that the exemption of the then-existing 5 (c) of the Securities Act would not be available unless the bonds should at the time of ultimate distribution be found only in the hands of investors resident within the State of New York.

Counsel for the issuer claimed that one reason for not registering the bonds was the inability to obtain firm commitments that would continue in effect during the time necessary for preparation of a registration statement, because the bankers would not hold the bonds during that period. All the bids submitted by the four underwriters contained identical provisions agreeing to comply with the Code of Fair Competition for Investment Bankers. Article IV of said Code, which expresses the obligations of issuers of securities, applies to offerings to the public exceeding $100,000. The identical bids significantly include an agreement by the Company to apply for listing on the New York

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22 Dahl, chairman of the board, was connected with Hayden, Stone & Co. prior to 1923; C. B. Sargent, a director of the company, was and is a partner in G. M. P. Murphy & Co., which received substantial allotments of bonds at less than the offering price to the public, though counsel for the company asserted the issuers had no knowledge of any contemplated distribution to G. M. P. Murphy & Co.

23 There were fourteen directors present. The four interested directors withdrew from the meeting.

Stock Exchange upon request of the underwriters as well as to furnish permanent engraved coupon bonds therefor. The listing application of the issuer filed with the Committee on Stock List of the New York Stock Exchange stated: "Such Bonds were offered to the public at 98½ percent of the face amount thereof, plus accrued interest."

Again, on June 11, 1934, when the bonds were delivered in temporary form, the four bankers advised the issuer that in their disposition of the bonds they had employed and would employ no means or instruments of transportation or communication in interstate commerce or of the mails. Counsel for the issuer described these letters as "an understanding at the time the agreement was signed, but not included in the agreement. It was collateral to it."

Finally, counsel for the issuer, when questioned as to the actual knowledge of the issuer as to the resale of the bonds answered: "* * * The Brooklyn Manhattan Transit Corporation, I assume, knew or assumed that these bankers would dispose of at least part of the bonds."

The Commission upon the basis of the foregoing evidence, finds that the issuer in fact knew that the four banking firms were purchasing with a view to the distribution of such bonds to the public and further finds that such banking firms were acting as "underwriters" for the issuer. * * *

The question presented on these facts was whether these bonds, assuming for the moment that the mails or instruments of transportation and communication in interstate commerce were employed, were exempt from registration upon the ground that they were an issue sold only to persons resident within the State of New York, within the meaning of either former Section 5 (c) of the Securities Act of the existing section 3 (11). * * *

The Federal Trade Commission with specific reference to the Brooklyn Manhattan Transit Corporation issue, expressed the opinion that in order that the exemption of Section 3 (a) (11) might be available "it is clearly required that the securities at the time of completion of ultimate distribution shall be found only in the hands of investors resident within the State." F. T. C. Securities Act of 1933, Release No. 201. A similar opinion as shown by this record was rendered to counsel for the New York Stock Exchange by the Chief of the Securities Division of the Federal Trade Commission in a letter under date of July 28, 1934. Counsel for the company has admitted that the Chief of the Securities Division also gave a similar opinion orally to counsel for the underwriters, who reported it to the issuer, early in May 1934, before the bonds were offered.

Counsel for the company urged that the sales of the bonds to the four underwriters, copartnerships formed under the laws of the State of New York, were alone sufficient to give the bonds the character of "an issue sold only to persons resident within" the State of New York. * * *

In the customary course of distribution, securities pass from the issuer into the hands of underwriters, thence either directly into the hands of investors or into the hands of dealers who in turn pass the

securities on to investors. These steps in the distribution of an issue are recognized and provided for, with a view to the protection of the ultimate investors, under the Securities Act. As a result of Section 4 (1) of the Act, the requirements of Section 5 with respect to registration and the furnishing of a proper prospectus meeting the requirements of Section 10 apply not only to transactions by the issuer and the underwriters but also to transactions by dealers during a period when such transactions are presumed to constitute a part of the distribution of the issue. Thus, the third clause of Section 4 (1) provides for an exemption for dealer's transactions as follows:

"Transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except transactions within one year after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter (excluding in the computation of such year any time during which a stop order issued under Section 8 is in effect as to the security), and except transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter." * * *

[The Securities Act, 1933] is, in the main, concerned with the problem of distribution as distinguished from trading. Obviously, an act designed to afford regulatory protection for investors in connection with the distribution of new security issues demands that its various component provisions should be construed in harmony with its general purpose. To construe the language of the former Section 5 (c) or of the present Section 3 (a) (11) in the way urged by counsel for Brooklyn Manhattan Transit Corporation, so that any issuer might wholly escape from the regulatory provisions of the act by the simple device of making an original sale of a new security issue to one person residing in the same state as the issuer, followed by immediate interstate distribution by that person, would ignore the realities of the mechanics of distributing securities and nullify the expressed purpose of Congress. In the present case, the issuer apportioned the new bonds among the four principal banking houses whose representatives sat upon its board of directors. Under other circumstances, the entire issue might have been sold to a single underwriter, and similarly distributed at once to the public pursuant to a plan fully known and assented to by the officers of the issuer. Yet, in that case, the contention would likewise be presented that the single sale to a selected resident of the State of residence of the corporation should forever after exempt the securities from the provisions of the Securities Act, however wide-spread the interstate distribution. The contention is wholly untenable. * * *

In the absence of explicit language in Sections 5 (c) and 3 (a) (11) fixing the point at which the sale of the issue to residents is to be taken into account, that point must be determined by a reasonable construction of the provision, which will accord with the general intent and purpose, and with the other provisions of the Act. The language, reasonably construed cannot contemplate a consideration of every

sale of an issue from the date of issuance till maturity. Clearly, also, as just pointed out, it does not contemplate only original sales by the issuer. Considering the clear purpose of the Act to control and regulate the distribution of new securities issues, it becomes clearly apparent that the sales of securities of an issue which are to be taken into account for the determination of whether the issue is sold only to residents of a State are the sales in connection with the distribution of the issue to the public. The point at which such distribution is completed is a question of fact to be determined in the light of all the circumstances of the offering.

As already noted, the Securities Act incorporates in Section 4 (1) a presumption that sales by dealers within a period of one year from the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter are a part of the distribution of the issue. That presumption which Congress adopted should be applied here, not, however, as a conclusive presumption of law, as in the third clause of Section 4 (1) of the Act, but as a presumption of fact subject to refutation upon a showing of fact that distribution was completed within less than one year.

In the present case, the Commission is not called upon to determine whether distribution of the Brooklyn Manhattan Transit Corporation bond issue is now, or was at any particular time, completed. The finding that on September 1, 1934, a negligible amount of bonds remained in the hands of dealers would indicate that distribution may then have been completed. On the other hand, the existence at that time of very substantial amounts of bonds in the hands of corporations and trust funds controlled by the underwriters and subunderwriters may indicate a mere temporary pause in the process of distribution.

The Commission has found that an aggregate of $1,198,000 principal amount of bonds were sold to nonresidents by the underwriters, the subunderwriters, dealers purchasing directly or through intermediate dealers from the underwriters or subunderwriters, and by persons purchasing from the underwriters or subunderwriters, whose transactions characterize them as being equivalent to dealers. All such sales were clearly a part of the distribution of the issue and the finding that approximately 15 percent of the issue was thus sold to nonresidents prior to the completion of distribution conclusively negatives the existence of any exemption for the issue under either the former Section 5 (c) or the existing Section 3 (a) (11), and renders it unnecessary to pursue further an inquiry as to the point, if yet attained, of actual completion of distribution of this issue. * * *

NOTE

The exemption permitted by Section 3 (b) of the Act is not complete exemption from all provisions of the Act. It is limited by express provisions in Section 12, which imposes civil liability on persons who sell securities in interstate commerce or through the mails by means of untrue statements or misleading omissions, and in Section 17, which makes it unlawful to sell securities by such means or by other types of fraud. Each of these sections by its own terms is applicable to transactions regardless of whether the securities involved have been ex-

empted under Section 3 (b). The principal effect of a Section 3 (b) exemption is to permit the sale of securities on the basis of a less complete disclosure than that required by the Act in the case of a registered security. Moreover, civil liabilities will be incurred only by the seller and the person controlling the seller, while in the case of the sale of a registered security, the full and fair disclosure described in the Act is required to be made and the civil liabilities of Section 11 run against all the persons specified in that Section. This latter sanction against practically all persons concerned in the distribution of a security is one of the most important of implements in carrying out the policy of the Act since it results in a concerted effort on the part of all concerned to provide full and fair disclosure of the character of the securities offered. (Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934-1944, p. 6.)

In the Matter of UNITY GOLD CORPORATION.

3 S.E.C. 618, 1938.

Findings and Opinion of the Commission

This is a proceeding to determine whether a stop order should issue under Section 8 (d) of the Securities Act of 1933, suspending the effectiveness of the registration statement filed on Form A-1 by the Unity Gold Corporation on May 25, 1937.

The registrant, a Montana company incorporated on June 29, 1934, a successor in reorganization to a Colorado corporation of the same name against which a stop order was issued on June 27, 1934, by the Federal Trade Commission, which then administered the Securities Act of 1933. In the Matter of Unity Gold Corporation, 1 S.E.C. 25, 18 F.T.C.649, 1934. Its incorporators were a group of stockholders of the North Butte Mining Company, a Minnesota corporation, which is under common control with the registrant and which has assumed responsibility for the registrant's corporate management since the date of its organization. * * * The registrant has an authorized capitalization of 1,000,000 shares of common stock of a par value of 10 cents a share, of which 380,367 shares are outstanding. The registration statement covers the remaining 619,633 shares, which are authorized but unissued. The registrant's properties have been actively operated since May, 1935, but are still admittedly in the development stage.

[Subsequent to the effective date of the registration statement, June 14, 1937, a number of amendments to the registration statement were filed.]

* * * Our discussion will accordingly be limited primarily to the deficiencies which would remain on the assumption that the proposed amendments were a part of the original registration statement. These deficiencies are to be found in Items 18, 20, 25, 31, 34, 36, 38, 46 and 54, and in the prospectus.

1. *Sales of Unregistered Shares in Violation of Securities Act (Items 25, 36, 38, as proposed to be amended).* The initial question for discussion requires a determination whether sales by the registrant

of certain shares of its stock not covered by the registration statement constituted a violation of Section 5 (a) of the Securities Act of 1933, 15 U.S.C.A. § 77e(a). It is the registrant's contention that the shares were exempt from registration under the provisions of the Commission's Securities Act Release Number 182 and of Rule 202, adopted under Section 3 (b) of the Act, 15 U.S.C.A. § 77c(b). However, the authority conferred upon the Commission by Section 3 (b) of the Act to provide by rules and regulations exemptions for particular classes of securities is limited by a specific proviso that "no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $100,000." The scope of the exemptions provided under this section of the Act must be construed in the light of this limitation. If, therefore, the unregistered shares in question comprised part of a single "issue" offered to the public at a price in excess of $100,000, this exemption was not available. In that event, although the original answers to Items 25, 36 and 38 would not be deficient on this ground, the proposed amendment of November 1, 1937, to these items would be materially misleading in volunteering the affirmative statement that all the stock issued since the organization of the company had been sold in conformity with the exemption.

On March 19, 1937, the registrant entered into two contracts, covering the disposition of 600,000 shares of its authorized but unissued stock. By the terms of the first agreement, entered into with John L. Cronan of New York City, Cronan purchased 75,000 shares of the company's stock for $47,812.50 (to be paid in cash upon execution and delivery of the agreement) and was given an option to purchase on or before October 15, 1938, 25,000 shares more at 63¾ cents per share. It was further agreed that the company would file a registration statement with this Commission, and that by the first day of the month immediately after the statement should become effective Cronan would purchase an additional 10,000 shares for 50 cents per share. This was a firm commitment. Lastly, Cronan was given an option for 190,000 shares at 50 cents per share, exercisable in increasing amounts at 11 monthly intervals beginning the first day of the second month following the effective date of registration. * * * The second agreement was with the North Butte Mining Company. Entered into in substitution for a previous agreement dated January 16, 1936, it gave North Butte an option to purchase 300,000 shares of the registrant's stock at 50 cents per share. This agreement would terminate unless exercised to the extent of 10,000 shares on the first day of each month, beginning August 1, 1938, until exhausted, i. e., until January 1, 1941. * * *

The underwriting agreement with Cronan did not contemplate that the 75,000 shares which were purchased outright would be registered, and in fact they were not. Cronan asserted that these shares were offered to the public under a prospectus of the registrant dated May 1, 1936, which had been filed with the Commission on July 27, 1936, in order to comply with the conditions of the exemption provided by Rule 202. This prospectus covered an offering of 80,000 shares of

the registrant's stock at 75 cents per share. The question, however, is whether the 75,000 shares comprised part of the same "issue" as the shares covered by the registration statement subsequently filed. If this was the case, the exemption was not available.

The manifest purpose of the $100,000 proviso contained in Section 3(b) of the Act is to limit the exercise of the Commission's exempting power to cases of small financing. It follows that the proviso cannot be construed to permit the exemption of small portions of large financing operations. This would defeat its very purpose. Thus, securities of the same class, offered on the same general terms to the public in an uninterrupted program of distribution, cannot be segregated into separate "issues" merely by claiming an exemption for a limited portion of such shares under Rule 202, or under any other rules of the Commission adopted in accordance with Section 3(b) of the Act, and registering the remainder. Nor can this be accomplished, it may be noted, by the mere formality of filing successive prospectuses under one or more of these rules if in fact the shares thereby offered otherwise constitute a single "issue" within the meaning of Section 3(b).

The determination whether securities are being offered as part of a single "issue" will depend upon a consideration of various factors concerning the methods of sale and distribution employed to effect the offerings and the disposition of the proceeds. If the offerings may be segregated into separate blocks, as evidenced by material differences in the use of the proceeds, in the manner and terms of distribution, and in similar related details, each offering will be a separate "issue." In the main, of course, each case must be determined upon the basis of its own facts. Proof of the relevant facts ordinarily can be obtained from such sources as the appropriate corporate records, contemporaneous agreements, and statements set forth in the prospectus.

Considered in the light of the foregoing, the record leads to the conclusion that the 75,000 shares which were purchased by Cronan and which were not registered were part of the same "issue" as the shares covered by the registration statement. The inference is clear—to be drawn from the provisions of the two contracts entered into on March 19, 1937, with Cronan and North Butte—that as of that date the registrant entered upon a detailed program, to extend over a considerable period of time, for the ultimate distribution of 600,000 shares of its stock. Except for variations in detail within the framework of the agreements respecting the issuance of particular shares, it is clear that these contracts involved a single, integrated plan for the distribution of these 600,000 shares. Accordingly, for the purposes of Section 3(b) of the Act the initial 75,000 shares purchased by Cronan cannot validly be claimed to constitute a separate "issue," and we find therefore that they were not exempt under Rule 202. Consequently, the proposed amendments to Items 25, 36 and 38 are deficient in the particulars heretofore noted. * * *

(b) Transactions

EXEMPTED TRANSACTIONS

Sec. 4. The provisions of section 5 shall not apply to any of the following transactions:

(1) Transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering; or transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except transactions within one year after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter (excluding in the computation of such year any time during which a stop order issued under section 8 is in effect as to the security), and except transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.

(2) Brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders. Securities Act of 1933, 15 U.S.C.A. § 77d.[24]

SECURITIES AND EXCHANGE COMMISSION v. SUNBEAM GOLD MINES CO. et al.

Circuit Court of Appeals of the United States, Ninth Circuit, 1938. 95 F.2d 699.

DENMAN, CIRCUIT JUDGE. This is an appeal by the Securities and Exchange Commission from an order denying a temporary injunction. The Commission brought a suit in equity against the defendant corporation seeking to enjoin it from an intended issue of securities without disclosing their character and registering them with the Commission pursuant to section 6 et seq., of the Securities Act of 1933, as amended, 15 U.S.C.A. § 77f et seq.

The facts are as alleged in the complaint and affidavits filed. They are not in dispute. The defendant Sunbeam Gold Mines Company is a Nevada corporation with stockholders in various states of the Union. Sometime prior to April, 1937, it entered into an agreement with another company, the Golden West Consolidated Mines, to purchase all the assets of the latter, subject to the approval of the stockholders of both companies.

This deal was subsequently approved by the stockholders of both companies. They gave their powers of attorney for the consolidation of the two companies, but this had not been accomplished when the bill was filed.

While the agreement was pending this approval, and on April 26, 1937, the defendant company issued through the mails a number of letters, 530 to be exact. Of the 530 recipients, 115 were stockholders of the defendant Sunbeam Company; 207 were stockholders of the Golden West Mines, and 208 were stockholders of both companies. These 530 people were scattered through various states.

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[24] See Rule 152; Note, 1939, 24 Wash.U.L.Rev. 383; Note, 1936, 45 Yale L.J. 1076, 1902.

The letters solicited pledge loan agreements from the stockholders for the purposes of completing the purchase by Sunbeam Company of the assets of the Golden West Mines and of raising enough money to register a contemplated new issue of stock with the Securities and Exchange Commission.

Upon signing the pledge loan agreement, the stockholder was to receive a "shareholder's receipt"—in effect a promissory note of Sunbeam Company—promising to repay the sum loaned with interest. The complaint alleges that the defendant proposes to send through the mails these shareholders' loan receipts to the 530 mixed stockholders of Sunbeam Company and Golden West Mines; that such a shareholders' loan receipt is a security within the meaning of the Securities Act, and hence is subject to registration with the Commission. The Commission brought this suit under section 20(a) of the act, 15 U.S.C.A. § 77t(a), authorizing injunctions against issuance of securities in violation of the act.

The court below, in denying an interlocutory injunction, held that the shareholders' loan receipt was a security within the meaning of the act, and that its distribution through the mails over state lines would make it subject to the required registration proceedings unless it came within the following exception stated in section 4(1) of the act, 15 U.S.C.A. § 77d(1), that the provisions of section 5 as amended, 15 U.S.C.A. § 77e, making unlawful the distribution of securities without registration:

"Shall not apply to any of the following transactions: * * *

"Transactions by an issuer not involving any public offering."

The court denied the injunction on the sole ground of its interpretation of this exception as meaning that such a distribution to stockholders did not involve a public offering. The language of its conclusion of law is: "The transactions by the defendants herein being solely with stockholders of Sunbeam Gold Mines Company and Golden West Consolidated Mines, all of said stockholders being stockholders of respondent company through merger of said corporations do not, irrespective of the number of said stockholders, involve a public offering within the meaning of section 4(1) of the Securities Act of 1933, as amended, and the plaintiff's application for preliminary injunction is therefore denied."

At the hearing here both parties agreed that the correctness of the conclusion of law last stated is the sole question involved in the appeal. They also agree that it is the sole question involved in the case itself, and that its decision will dispose of the entire litigation. Since the findings of fact are unquestioned and agreed to be a full statement of the case, and since they show no ground for the exercise of discretion, no presumption arises that the court otherwise properly exercised it in denying the injunction. We are therefore warranted in considering and disposing of the appellant's challenge of the lower court's conclusion of law. * * * [Citations omitted.]

The purpose of the Securities Act is stated in its title to be: "To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to pre-

vent frauds in the sale thereof and for other purposes." 48 Stat. 74.

Sections 6, 7 and 8, 15 U.S.C.A. §§ 77f to 77h, contain the provisions for the "disclosure" of information as to the security to be offered which shall be available to those to whom the offer is to be made. Section 4(1) makes an exception of those "transactions by an issuer not involving any public offering." Being an exception from the general policy of the act, anyone claiming to be within its terms has the burden of proof that he belongs to the excepted class—that is, that his offer is not to the public. Schlemmer v. Buffalo R. & P. R. Co., 205 U.S. 1, 27 S.Ct. 407, 51 L.Ed. 681, and cases there cited.

Furthermore, the terms of such an exception to the "general policy" of the act must be "strictly construed" against the claimant of its benefit. Spokane & Inland R. Co. v. U. S., 241 U.S. 344, 350, 36 S.Ct. 668, 671, 60 L.Ed. 1037.

The question here is, What was the Congress' intent when it required that the detailed information concerning the security should be made available to everyone considering its purchase, and then excepted transactions by an issuer not involving any "public" offering?

Appellees contend that the phrase "public offering" has but a single clear meaning, and that it is in effect equivalent to an offer to everyone. Hence, it is claimed, a restriction of an offer to a particular group of persons, such as here the 323 stockholders of the offering company and the 207 stockholders of the company sought to be merged with the offerer, must be a private rather than a public offering.

We cannot accept this contention. On the contrary, we agree with the view of the appellant that the word public "is one familiar to everyone, but of the most varied and indefinite connotations. In its broadest meaning the term 'public' distinguishes the populace at large from groups of individual members of the public segregated because of some common interest or characteristic. Yet such a distinction is inadequate for practical purposes; manifestly, an offering of securities to all red-headed men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation or the American Telephone & Telegraph Company, is no less 'public', in every realistic sense of the word, than an unrestricted offering to the world at large. Such an offering, though not open to everyone who may choose to apply, is none the less 'public' in character, for the means used to select the particular individuals to whom the offering is to be made bear no sensible relation to the purposes for which the selection is made. For the purposes of an offering of securities, red-headed men, residents of San Francisco, and stockholders of General Motors are as much members of the public as their antithetical counterparts. To determine the distinction between 'public' and 'private' in any particular context, it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction."

Since the phrase "public offering" does not ex vi termini determine its interpretation with reference to its exceptive purpose, it is proper to consider the reports of the committees of the two Houses of Con-

gress and of the Conference Committees of both in the progress of the original bill through its amendments to its enactment. U. S. v. Great Northern R. Co., 287 U.S. 144, 154, 53 S.Ct. 28, 31, 77 L.Ed. 223.

The bill as originally passed by the House, following the recommendation of the Committee on Interstate and Foreign Commerce, exempted from registration requirements the issuance of additional capital stock of the issuer among its own stockholders exclusively, where no commission or other remuneration was paid or given in connection with the sale or distribution, H.R. 5480, 73d Cong., 1st Sess., Sec. 4(3). This original House draft also exempted "transactions by an issuer not with or through an underwriter and not involving any public offering. * * *" Section 4(1). In reporting to the House, the Commerce Committee said of this exemption: "Paragraph (1) broadly draws the line between distribution of securities and trading in securities, indicating that the act is, in the main, concerned with the problem of distribution as distinguished from trading. It therefore exempts all transactions except by an issuer, underwriter, or dealer. Again, it exempts transactions by an issuer unless made by or through an underwriter so as to permit an issuer to make a *specific or isolated sale of its securities to a particular person,* but insisting that if a sale of the issuer's securities should be made generally to the public that that transaction shall come within the purview of the act." (Italics supplied.) H.R.Rep.No.85, 73d Cong., 1st Sess. p. 15.

Thus on the first draft of the measure it is clear that neither the Committee nor the House considered the test of "public offering" to be the inclusion or noninclusion of nonstockholders of the issuer in the group to whom the security was to be issued.

When the Senate received the measure, it eliminated the exemption contained in section 4(3), supra (including an exemption of stock dividends). The bill then went to conference, where the Senate's elimination of this exemption was approved by the Managers on the Part of the House, who stated, H.R.Rep.No.152, 73d Cong., 1st Sess. p. 25: "The House provision (Section 4(3) exempting stock dividends and the sale of stock to stockholders is omitted from the substitute since stock dividends are exempt without express provision as they do not constitute a sale, not being given for value. *Sales of stock to stockholders become subject to the act unless the stockholders are so small in number that the sale to them does not constitute a public offering.*" (Italics supplied.)

Again, in 1934, when the Securities Act was amended, 15 U.S.C.A. § 77b et seq. and notes, a proposal to exempt from registration securities offered by an issuer to its employees was rejected by the Committee of Conference of the two Houses. In this connection, the Managers on the Part of the House stated: "The conferees eliminated the third proposed amendment to this subsection on the ground that the participants in employees' stock-investment plans may be in as great need of the protection afforded by availability of information concerning the issuer for which they work as are most other members of the public." H.R.Rep.No.1838, 73d Cong., 2d Sess., p. 41.

These Reports clearly demonstrate that the Congress did not intend the term "public offering" to mean an offering to any and all members of the public who cared to avail themselves of the offer, and that an offering to stockholders, other than a very small number, was a public offering.

Cases are cited by the appellees in which are given interpretations of the word "public" in regulatory statutes. None is shown to have the legislative history of the Securities Act and none applies the rule of strict construction of the instant exception to the general policy of the legislation required by the Supreme Court.

We therefore hold that an offering of securities under the Securities Act of 1933 may be a public offering though confined to stockholders of an offering company, a fortiori where the offerees include the stockholders of another company though seeking to become stockholders of the offeror.

Since the burden of proof is on the company claiming the benefit of the exception, and since it admits that it has no further facts to submit concerning the offeree stockholders than that they are stockholders, we are not required to determine whether such an offer becomes private rather than public if each of the 530 stockholders were shown to know everything about the mining properties, their operation, and the financial condition of the company, which would be disclosed if the management had complied with the Securities Act and furnished the information to the Commission.

The order denying the injunction is reversed, and the cause remanded for the further action of the District Court in view of the admission here that the companies rest the final decision of the case on the ruling on the order denying the temporary injunction.

Reversed.[20]

NOTE

(A) Offers to participate in the "Mining Truth Blind Pool of 1937" were limited to the 600 subscribers of a mining investment advisory service. Held: the transaction nevertheless involved a "public offering" within the meaning of Section 4 (1). Securities and Exchange Commission v. Mining Truth Publishing Co., U.S.Dist.Ct., E.Dist.Wash., N.Div., 1937; III C.C.H., Fed.Sec.Law Serv., ¶ 90,116.

(B) Unregistered treasury stock was offered by D Co. exclusively to its common stockholders, payments to go to a trustee for the purpose of redeeming preferred stock. Injunction denied, on the ground that the distribution was a "transaction by an issuer not involving any public offering." Securities and Exchange Commission v. Federal Compress and Warehouse Co., U.S.Dist.Ct., W.D.Tenn., W.Div., Nov. 13, 1936, III C.C.H., Fed.Sec.Law Serv., ¶ 90,106, appeal dismissed without prejudice on motion of appellants, 88 F.2d 1018, C.C.A.Tenn.1937.

See, also, Securities and Exchange Commission v. Lavey, U.S.Dist.Ct., E.Dist. Wash., N.Div., Mar. 15, 1937, I. C.C.H., Fed.Sec.Law Serv., ¶ 2911.27 where the court said it was doubtful whether "the soliciting of loans by a corporation from its lawful stockholders, exclusively, such loans, if any, to be evidenced by promissory notes to be executed by the corporation to the stockholders, amounts to a public offering * * *".

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[20] The principal case is noted in, 1938, 26 Calif.L.Rev. 505; 1937, 51 Harv.L.Rev. 360; 1938, 36 Mich.L.Rev. 604.

(C) ***Purchases by Life Insurance Companies of Securities Privately Offered.***— Prior to 1934, most securities acquired by life insurance companies had been those publicly offered, but the system of securities regulation, with its temporary repression of securities issues, induced the companies to purchase directly from the securities issuers, such sales being expressly exempted from regulation. That private financing constituted 16% of all corporate financing between January 1, 1934, and October 1, 1938, shows the importance which this new technique has assumed.

If the insurance company is interested in the offer made by the prospective issuer, by agents, or by bankers, the preliminary basic terms are determined in conferences between the issuer and the purchaser, and the transaction is then implemented by the negotiation of a purchase agreement, the initial draft of which is customarily prepared by the purchaser. Where practicable the indenture or supplemental indenture under which the securities are to be issued is attached in draft form to the purchase agreement. If available time does not permit this, the more important provisions of the proposed indenture are summarized in an exhibit to the purchase agreement which provides that the indenture shall incorporate such terms and shall be otherwise in form satisfactory to both the issuer and the purchaser. If there is more than one offeree, a single purchase contract form is finally agreed upon by all the purchasers and entered into by each of them with the issuer.

One of the main advantages of private financing is the elimination or reduction of the expenses incurred in public offerings, the average cost of which is 9.2% of the gross proceeds for issues under $250,000, 4.8% for issues from 1 to 10 million, 3.1% for issues from 10 to 25 million, and 2.3% for issues of over 25 million.

Economies effected by private financing are:

(1) Underwriting commissions are eliminated (amounting to 2.8% to 6.4% of gross proceeds for issues up to 10 million dollars);

(2) Legal expenses are reduced;

(3) Registration costs are eliminated (1/5 to 1/3 of 1% of total proceeds);

(4) Advertising costs are abolished ($3,000 for a 10,000,000 issue);

(5) Costs of printing registration statements, indentures, and the like ($10,000 to $30,000) and costs of preparing securities in small denominations ($2,500 for a $10,000,000 issue) are avoided;

(6) Transfer taxes, incurred when bankers acquire and distribute securities, are eliminated ($4,000 for a $10,000,000 issue);

(7) After the securities are acquired:

(a) Trustees fees are less (a saving of as much as $25,000 on a large issue);

(b) Cost of stock exchange listings for the securities are avoided (a minimum of $120 per $1,000,000); and

(c) Cost of publishing redemption notices (an economy of as much as $12,000 for large issues) and exchanges and transfers of securities are practically abolished.

To the issuer a more important advantage of private financing than the saving of expenses is the speed of placement which it affords. It takes fifty to eighty days, as a minimum, to prepare and make effective a registration statement, and this too readily allows market conditions to become adverse. Thus the issuer, at the last moment, may find it impossible to get underwriters to take the securities and thus have to cancel the effort and expense put into the preparation. Another important consideration for the issuer is that, with but one purchaser, provisions of the indenture can be easily adjusted in case of unforeseen events, a procedure almost impossible to carry out if the security holders are numerous and widely scattered.

In answer to the criticism of private financing that it is a circumvention of the spirit of the securities laws, it is pointed out that such laws were enacted to protect the ordinary investor who was ill-equipped to inform himself as to the worth of the securities. The argument is also made that private financing destroys

the marketability of securities so purchased. To this the answer is made that the insurance companies buy these securities not for purposes of resale but for the investment afforded, that from the company's standpoint, their portfolios contain many other securities which are readily marketable, and that anyway the same criticism can be made as to the large block purchases made of publicly offered securities. Again, it is said that private financing deprives the smaller life insurance companies of a chance in participation. To a certain extent this is true, since issuers of large amounts of securities must turn to sources which can absorb the entire issue in order to keep the transaction within the scope of the exemption. However, smaller companies can and do engage in private purchases.

It has been suggested that issuers cannot do private financing without impairing their relationship with the bankers and injuring the market for their own junior securities, and that if the investment bankers take the risk connected with the distribution of equity securities they should have the profits of participating in the sale of the higher-grade loans. But, as previously stated, private placement with the insurance companies by enhancing the credit standing of the issuer may well improve the marketability of its junior securities. If junior securities have a market, the bankers will be glad to distribute them * * * Likewise * * * if (they) * * * do not have a market, the bankers are hardly to be expected to distribute such junior securities at a loss to themselves. Condensed from Rodgers, Purchase by Life Insurance Companies of Securities Privately Offered, 1939, 52 Harv.L.Rev. 773.

See, also, S.E.C., Opinion of General Counsel as to "Public Offerings", Rel. No. 285, I C.C.H., Fed.Sec.Law Serv., ¶ 2266.17.

OPINION OF GENERAL COUNSEL OF COMMISSION CONCERNING EXEMPTION CREATED BY SEC. 4(1) OF SECURITIES ACT.

The Securities and Exchange Commission, feeling that the present tendency of large issuers to resort to so-called "private financing" may in many instances be at variance with the law, and that such a tendency is undesirable from the standpoint of thousands of prospective investors who are likely to be deprived of opportunities to participate in sound issues through this device, has today made public the following opinion of its General Counsel, John J. Burns. This opinion concerns the exemption created by the second clause of Section 4(1) of the Securities Act, which exempts "transactions by an issuer not involving any public offering."

Some misunderstanding has arisen as to the meaning of this provision because correspondents have failed to confine previous opinions of the General Counsel to the exact facts on which the opinions were based. The present opinion indicates the many factors which must be considered in determining the availability of this exemption, and points out that a definite opinion in advance is impossible except in a few clear cases.

The principal factors to be considered are: 1. The number of offerees and their relationship to each other and to the issuer; 2. The number of units offered; 3. The size of the offering; and 4. The manner of offering. Issuers are also warned of the practical difficulty which purchasers would have in redistributing securities originally issued without registration in reliance on this exemption.

The full text of the opinion, which was given in the case of a proposed offering of $1,766,000 of Preferred Stock to 25 offerees, follows:

"The opinion has been previously expressed by this office that an offering of securities to an insubstantial number of persons is a transaction by the issuer not involving any public offering, and hence an exempted transaction under the provisions of Section 4(1) of the Securities Act. Furthermore, the opinion has been expressed that under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number and presumably does not involve a public offering.

"As a result of such opinions there appears to be developing a general practice on the part of issuers desiring to avoid registration of their securities to seek to dispose of the same to insurance companies or other institutions, which, at the time of purchase, state that they are acquiring such securities for investment and not with a view to distribution.

"I would call your attention to the fact that in previous opinions it has been expressly recognized that the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment. In no sense is the question to be determined exclusively by the number of prospective offerees. I conceive that the following factors in particular should be considered in determining whether a public offering is involved in a given transaction;

1. The Number of Offerees and Their Relationship to Each Other and to the Issuer

"You will note that this does not mean the number of actual purchasers, but the number of persons to whom the security in question is offered for sale. The word "offering" in this sense should not be limited to those cases wherein a formal proposal for a firm commitment is submitted. Any attempt to dispose of a security should be regarded as an offer. I have very serious doubt as to whether in many of those cases where it is stated that an offering is to be made only to an insubstantial number of persons, there may not be preliminary conversations for the purpose of ascertaining which of various possible purchasers would be willing to accept an offer of the security in question if it were made to them. Any such preliminary negotiations or conversations with a substantial number of prospective purchasers would, in my opinion, cause the offering in question to be a public offering, thereby necessitating prior registration of the security in question.

"Again, in determining what constitutes a substantial number of offerees, the basis on which the offerees are selected is of the greatest importance. Thus, an offering to a given number of persons chosen from the general public on the ground that they are possible purchasers may be a public offering even though an offering to a larger number of persons who are all the members of a particular class, membership in which may be determined by the application of some pre-existing standard, would be a non-public offering. However, I have no doubt

but that an offering restricted to a particular group or class may nevertheless be a public offering if it is open to a sufficient number of persons.

"I also regard as significant the relationship between the issuer and the offerees. Thus, an offering to the members of a class who should have special knowledge of the issuer is less likely to be a public offering than is an offering to the members of a class of the same size who do not have this advantage. This factor would be particularly important in offerings to employees, where a class of high executive officers would have a special relationship to the issuer which subordinate employees would not enjoy.

2. The Number of Units Offered

"If the denominations of the units are such that only an insubstantial number of units is offered, presumably no public offering would be involved. But where many units are offered in small denominations, or are convertible into small denominations, there is some indication that the issuer recognizes the possibility, if not the probability, of a distribution of the security to the public generally. The purpose of the exemption of non-public offerings would appear to have been to make registration unnecessary in those relatively few cases where an issuer desires to consummate a transaction or a few transactions and where the transaction or transactions are of such a nature that the securities in question are not likely to come into the hands of the general public.

"In connection with a consideration of the number of units offered, I would also consider whether the same or other securities of the same issuer are being offered at the same time. I feel that this circumstance has a bearing on the character of the offering.

3. The Size of the Offering

"It should be noted that the exemption of Section 4(1) is of transactions by an issuer not involving any public offering. In view of this language, it would appear to be proper to consider not merely the specific transaction or transactions between the issuer and the initial purchasers, but also the extent to which a later public offering of all or part of the securities sold by the issuer is likely. Hence I feel that this exemption was intended to be applied chiefly to small offerings, which in their nature are less likely to be publicly offered even if redistributed.

"For the same reason I feel that a material consideration is whether the security in question is part of an issue already dealt in by the public, either on a national securities exchange or on the over-the-counter market, or, within the reasonable contemplation of the parties, is likely thus to be dealt in shortly after its issuance. This factor again may indicate whether public distribution of the security in question is likely within a reasonable time.

4. The Manner of Offering

"I have already indicated my opinion that the purpose of the exemption of non-public offerings is largely limited to those cases wherein the issuer desires to consummate a few transactions with particular

persons. Consequently, I feel that transactions which are effected by direct negotiation by the issuer are much more likely to be non-public than those effected through the use of the machinery of public distribution.

"I have gone into this matter at length in order that you may be apprised of the many elements which in my opinion go into the determination of what constitutes a transaction not involving any public offering. There may be some situations where all the factors are so clear that it would be possible to express a definite opinion. In a situation such as you present, however, I feel that the offering would be carefully scrutinized by any court before which it may come and that any letter which purported to describe the situation, and on which my opinion would necessarily be based, could not adequately advise as to the various factors which are involved.

"I call your attention to the fact that any dealer who might subsequently purchase from an initial purchaser the securities which you propose to offer would be required to satisfy himself that the initial purchaser had not purchased with a view to distribution. If the initial purchaser had purchased with this intent, he would be an underwriter, and sales by a dealer of securities bought by him from such an initial purchaser would, as a general rule, not be exempt until at least a year after the purchase of the securities by the dealer. The sale of unregistered securities to a limited number of initial purchasers, therefore, leads to a practical situation in which such initial purchasers may have difficulty in disposing of the securities purchased by them. Any opinion which I might render in connection with the proposed offering might, I fear, be availed of by the issuer or by an initial purchaser as a means of satisfying a dealer, at a later date, that he might purchase the securities in question and market them without risk of violating the Act. You will appreciate that my opinion would not actually have this effect, since in the case of each transaction there would be involved various matters of fact on which I am not in a position to express an opinion.

"Accordingly, it seems a much wiser policy for me not to express an opinion in the situation which you present as to whether a public offering is involved."

IN THE MATTER OF IRA HAUPT & COMPANY

Exchange Act Release No. 3845, August 21, 1946.

[The first part of the case appears infra, p. 796.]

* * * 3. *Is the brokerage exemption of Section 4 (2) available to an underwriter who effects a distribution of an issue for the account of a controlling stockholder through the mechanism of a stock exchange?*

Respondent's final argument on this phase of the case is that, notwithstanding the inapplicability of Sections 3(a) (1) and 4 (1) and even though Respondent may be found to be an underwriter, its transactions fall within Section 4 (2) which exempts "brokers' transactions,

executed upon customers' orders on any exchange * * * but not the solicitation of such orders." Counsel for the staff takes the position, first that Section 4 (2) can never apply to exempt the transactions of an underwriter engaged in a distribution for a controlling stockholder and, second, that, even if Section 4 (2) can apply in such a situation, its applicability in the present case is destroyed by activities of Respondent which exceeded the normal functions of a broker and by the further fact that Respondent engaged in the solicitation of customers' orders.

The applicability and scope of the brokerage exemption in Section 4 (2) can be properly considered only against the background of the policy and purpose of the entire Act. We have already pointed out that the primary purpose of the Act was to provide prospective investors, through the registration and prospectus requirements, with a source of reliable information on the basis of which they can reach informed judgments whether or not to buy securities publicly offered. And it has also been shown that these requirements and the policy of the Act apply not only to securities newly issued but also to secondary distributions by persons in control of the company whose securities they offer. It is this application of the Act to secondary distributions with which we are here concerned. What we must determine is whether the broad provisions which by their terms plainly require registration and the disclosure of pertinent information to prospective investors in the case of public distributions by controlling persons, through underwriters, are so limited by the general language of Section 4 (2) as to withdraw the basic protection afforded by the Act where the securities are offered to the public in an avid market by a method which we will assume, *arguendo,* foregoes the sales effort usually considered necessary to accomplish similar distributions.

It is clear from Section 4 (1), read in conjunction with Section 2 (11), that public distributions by controlling persons, through underwriters, are intended generally to be subject to the registration and prospectus requirements of the Act. Section 4 (1) exempts transactions "by any person other than an issuer, underwriter, or dealer," "transactions by an issuer not involving a public offering" and "transactions by a dealer" other than those "within one year after the first date upon which the security was bona fide offered to the public * * * by or through an underwriter. * * *" This shows a specific intention to subject to the registration and prospectus requirements public offerings by issuers or by or through "underwriters." And, as we have seen, Section 2 (11) defines "underwriter" to include any person who sells for the issuer or a person controlling the issuer in connection with the distribution of a security.

These sections, by their terms, provide that whenever anyone controlling an issuer makes a public distribution of his holdings, in the controlled corporation by selling through another person acting for him in connection with the distribution, the sales by which the distribution is accomplished are transactions by an underwriter which are subject to the registration requirements. Applied to such transactions by which substantial quantities of securities are disposed of to the pub-

lic, the registration requirement is consistent with and calculated to further the general purpose of the Act to provide investors with pertinent information as a means of self-protection. The legislative history of the Act strongly sustains this conclusion.[25]

We find nothing in the language or legislative history of Section 4 (2) to compel the exemption of this type of secondary distribution and the consequent overriding of the general objectives and policy of the Act. On the contrary, there are affirmative indications that Section 4 (2) was meant to preserve the distinction between the "trading" and "distribution" of securities which separates the exempt and non-exempt transactions under Section 4(1). This conclusion becomes apparent on examination of the legislative comments on Sections 4 (1) and 4 (2).

In referring to the exemption in Section 4 (1) for transactions by a person "other than an issuer, underwriter, or dealer," the House Report states:

Paragraph (1) broadly draws the line between *distribution* of securities and trading in securities, indicating that the act is, in the main, concerned with the problem of distribution as distinguished from trading. It, therefore, exempts all transactions except by an issuer, underwriter or dealer * * * (Italics ours.) [26]

And, in discussing the limited exemption for dealers in the third clause of Section 4(1), the House Report again emphasized the distinction between "trading" and "distribution":

"* * * Recognizing that a dealer is often concerned not only with the *distribution* of securities but also with *trading* in securities, the dealer is exempted as to *trading* when such *trading* occurs a year

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[25] See H.R.Rep.No.85, 73d Cong., 1st Sess., pp. 13-14 which in referring to the definition of "underwriter" in Section 2(11) states:

"The last sentence of this definition, defining 'issuer' to include * * * persons controlling the issuer has two functions * * * Its second function is to bring within the provisions of the bill redistribution whether of outstanding issues or issues sold subsequently to the enactment of the bill. *All the outstanding stock of a particular corporation may be owned by one individual or a select group of individuals. At some future date they may wish to dispose of their holdings and to make an offer of this stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities.* Wherever such a redistribution reaches significant proportions the distributor would be in the position of controlling the issuer and thus able to furnish the information demanded by the bill. *This being so, the distributor is treated as equivalent to the original issuer and, if he seeks to dispose of the issue through a public offering, he becomes subject to the act.* The concept of control herein involved is not a narrow one depending upon a mathematical formula of 51% of voting power, but is broadly defined to permit the provisions of the act to become effective wherever the fact of control actually exists." (Italics ours.)

See also the general statement of the purpose of the legislation at p. 5 of the same Report:

"The bill affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities *unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering.* It carefully exempts from its application certain types of securities and securities transactions where there is no practical need for its application or where the public benefits are too remote." (Italics ours.)

[26] H.R.Rep.No.85, 73d Cong., 1st Sess., p. 15.

after the public offering of the securities. Since before that year the dealer might easily evade the provisions of the act by a claim that the securities he was offering for sale were not acquired by him in the process of *distribution* but were acquired after such process had ended, transactions during that year are not exempted. The period of a year is arbitrarily taken because, generally speaking, the average public offering has been distributed within a year and the imposition of requirements upon the dealer so far as that year is concerned is not burdensome." (Italics ours.) [27]

From the foregoing, it is apparent that transactions by an issuer or underwriter and transactions by a dealer during the period of *distribution* (which period for purposes of administrative practicality is arbitrarily set at one year) must be preceded by registration and the use of a prospectus. It is likewise apparent that Congress intended that, during this period, persons other than an issuer, underwriter, or dealer should be able to *trade* in the security without use of a prospectus. Since such persons would carry on their trading largely through the use of brokers (who are included in the general definition of dealers),[28] such trading through brokers without the use of a prospectus could be permitted during the first year after the initial offering only if there were a special exemption for dealers acting as brokers. The importance of this special exemption is emphasized in the case where a stop order might be entered against a registration statement. For, although such a stop order was intended to and would operate to stop all *distribution* activities, it would also result in stopping all *trading* by individuals through dealers acting as brokers unless a special exemption were provided for brokers. It was in recognition of this fact and to permit a dealer to act as a broker for an individual's trading transactions, while the security is being distributed and during the period of a stop order, that Section 4 (2) was enacted. That this was the specific purpose of Section 4 (2) is clearly seen from the comment on this provision by the House Committee which considered the legislation:

Paragraph (2) exempts the ordinary brokerage transaction. *Individuals may thus dispose of their securities according to the method which is now customary without any restrictions imposed either upon the individual or the broker. This exemption also assures an open market for securities at all times, even though a stop order against further distribution of such securities may have been entered.* Purchasers, provided they are not dealers, may thus in the event that a stop order has been entered, cut their losses immediately, if there are losses, by disposing of the securities. *On the other hand, the entry of a stop order prevents any further distribution of the security.* (Italics ours.)

To summarize: Section 4(2) permits individuals to sell their securities through a broker in an ordinary brokerage transaction,

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[27] H.R.Rep.No.85, 73d Cong., 1st Sess., p. 16.

[28] Section 2 (12) defines the term "dealer" to mean "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."

during the period of distribution or while a stop order is in effect without regard to the registration and prospectus requirements of Section 5. But the process of distribution itself, however carried out, is subject to Section 5.

What we have said also disposes of Respondent's argument that Section 4(2) would be rendered meaningless if it were interpreted not to apply to an underwriter "acting as a broker." Respondent has argued that such an interpretation would confine the 4(2) exemption to an area already covered by the dealer's exemption in 4(1) and thereby render Section 4(2) surplusage. But our discussion of the legislative history indicates the fallacy of this argument. It shows that the primary purpose of Section 4(2) was that it be available for trading activities during the period of distribution and during the period when a stop order might be in effect—precisely at the time when the dealer exemption is not available. Thus, far from rendering Section 4(2) meaningless, our interpretation gives it meaning in the situation to which the legislative history shows it was intended to apply.

We conclude that Section 4(2) cannot exempt transactions by an underwriter executed over the Exchange in connection with a distribution for a controlling stockholder. Respondent has suggested that this conclusion is contrary to administrative interpretations issued by our staff and to the implications in recent orders issued in connection with applications of *The United Corporation* under the Public Utility Holding Company Act with respect to United's sale of common stock of a subsidiary through brokers on the New York Stock Exchange.[29] The administrative interpretations referred to were to the general effect that an underwriter selling for a controlling stockholder over the exchange might conceivably be entitled to the exemption under Section 4(2) if his activities were confined strictly to the usual brokerage functions, but that, as a practical matter, his activities could not be so confined in connection with a distribution of any substantial block of securities. These interpretations arrived at the same ultimate result as that which we have reached here. But the theory and the qualification of the interpretations—which we agree are inconsistent with our conclusion herein—were developed against the background of a very different market than is now prevalent. It has been only comparatively recently that the problem has been presented in the context of a market in which large blocks can frequently be sold without solicitations or other sales activity. In that context, the invalidity of the theory on which the interpretations were based has become apparent. * * *

NOTE

Company A had an "open end" mortgage upon its properties, the only issue of bonds then outstanding thereunder being denoted as Series A bonds. It was proposed to create two new series of bonds under the mortgage, to be called Series B and Series C bonds respec-

[29] The United Corporation, Holding Company Act Releases Nos. 6337 (1945), 6409 and 6649 (1946).

tively, for the purpose of refunding the outstanding bonds. The Series B and Series C bonds would differ substantially from each other in respect of maturity date, interest rate, redemption prices and default provisions. The Series B bonds would be offered in exchange to the holders of the outstanding Series A bonds on the basis of an equal principal amount of Series B bonds for those of Series A, with interest adjustment. No commission or other remuneration would be paid or given, directly or indirectly, for soliciting such exchange. The necessary funds to redeem any unexchanged Series A bonds would be raised by the sale for cash of Series C bonds. The Series C bonds would be offered and sold to not more than twelve insurance companies, which would agree to purchase for investment and without a view to distribution. The Securities and Exchange Commission ruled that the Series B and Series C bonds appeared to be securities of different classes, they constituted separate "issues," and could be offered and sold in the manner described without being registered under the Securities Act. Why? (Securities Act Release No. 2029, August 8, 1939.)

5. WHAT CONSTITUTES AN UNDERWRITER

NOTE

* * * (11) The term "underwriter" means any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer. * * *

Securities Act of 1933, 15 U.S.C.A. § 77b(11).

In the MATTER of SWEET'S STEEL CO.

4 S.E.C. 589, 1939.

Findings and Opinion of the Commission.

This is a proceeding under Section 8 (d) of the Securities Act of 1933, 15 U.S.C.A. § 77h (d), to determine whether a stop order should issue suspending the effectiveness of the registration statement of Sweet's Steel Company, the registrant.

* * * After amendment, the registration statement became effective on June 15, 1937. * * *

In January, 1937, control[30] of the registrant was vested in five banks, located in Williamsport, Pennsylvania, which owned 2,065 shares of the registrant's 4,227 outstanding shares of $100 par value common stock. Representatives of these banks formed a majority of the registrant's directors. Comstedt acquired an option to purchase most of this stock plus additional shares, bring-

[30] See Rule 451 for definition of control.

ing the total to 3,028 shares at $100 per share, or an aggregate of $302,800. The option originally ran until March 15, 1937, but was extended to April 15, 1937.

Comstedt, who was characterized by witnesses as a "promoter type" or a "finder", did not have sufficient funds to purchase the shares. Consequently, with the options in hand, he approached several investment banking houses for assistance. Late in March, 1937, he talked with G. L. Ohrstrom, president of Ohrstrom, Inc., an investment banking firm, who agreed to provide the money to exercise the option. It was planned to split up the old stock 25 for one and to distribute the new shares to the public through an underwriting agreement with some third party.

Ohrstrom, Inc., could not finance the purchase of the 3,028 shares without assistance. It obtained aid from two English banking firms which were unwilling to participate if disclosure of their names were required. Further, Ohrstrom, Inc., did not wish to be held out as having originated the underwriting, since it had a short time previously sponsored another small steel issue that had not been successful. Accordingly, Ohrstrom, Inc., instructed its counsel that it was unwilling to provide the $302,800, if it were required to be named as underwriter. Subsequently two agreements were drawn by its counsel, who advised Ohrstrom, Inc., that nothing therein made it an underwriter.

These agreements, one between Comstedt and Ohrstrom, Inc., and another between Comstedt and G. L. Ohrstrom & Co., were entered into on April 19, 1937. These contracts, which contemplated a split up of the shares and a public offering, provided that Ohrstrom, Inc., was to furnish Comstedt the $302,800 needed by him for the purchase of 3,028 shares of the registrant's $100 par value stock; these shares were to be held by Ohrstrom & Co. in escrow as collateral security for this so-called "loan"; all dividends and other rights pertaining to the ownership of the shares were to accrue to Ohrstrom, Inc.; and Ohrstrom, Inc., was constituted agent to deliver shares as they were resold. Of the 75,700 shares ($1 par value) into which the 3,028 shares ($100 par value) were changed, it was contemplated that 70,000 shares would be distributed to the public through an offer sponsored by some third party; 2,000 shares would be delivered to Comstedt, and 3,700 shares would be retained by Ohrstrom, Inc., as compensation for services. It was also contemplated that the 70,000 shares would be sold for the aggregate amount of $367,500, of which $302,800 would be used to repay the alleged "loan"; $5,000 would be paid to Comstedt; and $59,700 would accrue to Ohrstrom, Inc. The agreements further provided that Ohrstrom, Inc., at its election, could take over the stock for its own account in full discharge of Comstedt's obligations.

This agreement does not possess the normal attributes of a loan or pledge in that Comstedt could not redeem the stock; dividends were not to apply to reduction of the alleged loan; no interest was to be paid thereon; and Comstedt was to receive compensation in cash and shares of the registrant's stock. Further, it is clear that the so-called "loan" was to be repaid from the proceeds of distribution of the shares to the public.

Having consummated these arrangements Ohrstrom, Inc., caused $100,000 to be paid to the optionors through the medium of Comstedt, the latter having obtained an extension of the options conditioned on the payment of that sum by April 20, 1937. The balance of the purchase price, $202,800, was paid in the same manner on May 4, 1937. By charter amendment of May 20, 1937, each of the registrant's $100 par shares of common stock was split up into 25 shares of $1 par value.

Next, agreements were entered into with Amott, Baker to handle the public offering of shares owned by Ohrstrom, Inc., and of a new issue for the account of the registrant. Under these agreements Amott, Baker had the following obligations and rights: (a) a firm commitment to buy 24,325 shares of the new stock from the registrant and 33,000 shares from Comstedt at $5.25 per share; (b) an option to purchase an additional 37,000 shares from Comstedt at $5.25 per share; and (c) warrants to buy 60,000 additional shares from the registrant. The underwriting agreements of Amott, Baker were the only ones disclosed in the registration statement. No mention was made therein of the agreements between Ohrstrom, Inc., and Comstedt. * * *

Prior to the filing of the registration statement, Ohrstrom, Inc., placed two representatives in the employment of the registrant one of whom was elected a director. These persons' duties primarily consisted of carrying out suggestions made by Ohrstrom, Inc., as to the registrant's policies. Prior to a meeting of the Board of Directors on May 4, 1937, undated resignations of the registrant's directors were obtained by Ohrstrom, Inc.

* * * During the time that the Comstedt "loan" agreements were in effect, Ohrstrom, Inc., made what is considered bona fide sales of 13,275 shares of the "pledged" stock. G. L. Ohrstrom testified that he was not conscious of the agreements; that he considered the shares belonged to Ohrstrom, Inc.; and that it could sell them whenever it desired. It did just that despite the fact that the shares, at the time of the sales, had not been reduced to possession under the Comstedt agreements, and that no permission for the sales was obtained from Comstedt. Although the public distribution occurred after the effective date of the registration statement, the activities of Ohrstrom, Inc., with respect thereto are evidence of the construction which it placed on the "loan" agreements.

In view of the foregoing, the loan made by the Ohrstrom syndicate cannot be considered bona fide. We find that Comstedt in purchasing the shares was not acting in his own behalf but for Ohrstrom, Inc., and its syndicate. The real purpose of Ohrstrom, Inc., in disguising the purchase as a loan was to avoid disclosure of itself and its syndicate as underwriters in compliance with the requirements of the Act.

Thus it is clear that the position of Ohrstrom, Inc., and its syndicate, was that of an underwriter as that term is defined in Section 2 (11) of the Act. The banks from whom the securities were purchased pursuant to the first Comstedt option were in control of the issuer. They were consequently issuers within the meaning of Section 2 (11). One

purchasing from them with a view to distribution is an underwriter, and it is our finding that Ohrstrom, Inc., and members of the syndicate did purchase from those persons through the agency of Comstedt with a view to distribution. The nature of their interest is not compatible with that of a mere lender of money or a person performing a normal banking function. They were sharing the profits and risks of distribution.

Items 22, 23, and 24. The failure to name Ohrstrom, Inc., and its syndicate as principal underwriters, as well as the failure to indicate the affiliation of Ohrstrom, Inc., with the registrant in Item 22 makes the answer made to that item false and misleading and constitutes a material omission. * * *

Item 23 requires an outline of the material provisions of each underwriting contract with a principal underwriter. We find that the registrant's answer to this item omits facts required to be stated therein in omitting to outline the agreements between Comstedt and Ohrstrom, Inc.

Item 24 requires a statement of the price at which a security is to be offered to the public, the underwriting discounts, and the proceeds to be received by the issuer and by the stockholders in whose behalf the shares are offered. The registrant should have disclosed the total spread, that is, the difference between what Ohrstrom, Inc., and its syndicate paid to the prior owners and the amount at which the stock was to be sold to the public. The spread on the 70,000 shares involved in the syndicate transaction was $210,000, since the stock was purchased at $4 a share and retailed at $7 a share. The registration statement discloses only the spread between the price paid by Amott, Baker and the price to the public, which amounted to $122,500, or $1.75 a share. These misstatements constitute material deficiencies.

The remaining items to be considered are:

Item 5. This item requires a brief statement of the character of business done and intended to be done. The registrant's answer stated in part, "registrant does not contemplate any change in its present management." As above set forth, the registrant was under the control of Ohrstrom, Inc., which held undated resignations of the directors on the effective date of registration statement. Three days after the effective date of the registration statement, an officer of Ohrstrom, Inc., wrote, "The Board of Directors of the Company intends to make various changes with respect to the management. * * *" The evidence indicates that the changes which subsequently took place were contemplated at the time the registration statement became effective. We find that the answer to Item 5 was false and misleading.

Items 10, 33 and 34. In response to these items the registrant stated without qualification that 99,400 shares were owned by Comstedt. As has been said above, Comstedt's sole function was that of an intermediary for Ohrstrom, Inc. He was not the beneficial owner of the 99,400 shares of stock of the registrant on any of the dates indicated in these items. We conclude that these items contain untrue statements of material facts.

Item 26. This item requires a statement of persons to whom registered securities have been or are to be sold for a consideration varying from that at which the securities are to be sold to the general public. The registrant stated that no securities "are to be sold for a consideration varying from that at which the securities are to be sold to the general public." The record shows that Ohrstrom, Inc., had entered into an agreement with Belcaro Investment Co. to sell it 5,000 shares at $4.25 a share and to repurchase them at $5 a share within 60 days after the effective date of the registration statement. In order to fulfill this commitment Ohrstrom, Inc., purported to include Belcaro Investment Co. as a member of its syndicate. This was done without consultation with Belcaro Investment Co., which later contested the fact that it was a syndicate member. It seems clear that a person cannot be made a member of a syndicate against his will. We therefore conclude that Belcaro Investment Co. was not a member of the syndicate and that as of the effective date of the registration statement Ohrstrom, Inc., contemplated selling it securities at less than the price to the public. Therefore the answer to Item 26 was materially deficient. * * *

A stop order will issue in accordance with these findings and this opinion.

NOTE

(A) Although a mere "finder" who does no more than introduce a registrant to an underwriter and does not otherwise participate in the distribution may not himself be an "underwriter", the performance of a few additional services and the receipt of compensation therefor may bring a person within this category. Thus where B was to receive a cash sum plus a percentage of any financing it might obtain for the registrant, was to render financial advice, was to take an active part in the negotiations, and whose consent was required before the final consummation of any deal, it was held by the Commission that B was an underwriter. In the Matter of Puget Sound Distillery, Inc., 3 S.E.C. 355, 1938.

(B) (1) A, a stockholder of X Co., registrant, lent $1,000 to B to incorporate X Co. and register its securities, and "aided materially in the organization of the enterprise". A is a "promoter". In the Matter of Doris Ruby Mining Co., 4 S.E.C. 427, 1939. Cf. In the Matter of Gold Dust Mining & Milling Co., 3 S.E.C. 55, 1938.

(2) A law partner of the principal promoter and owner of all the voting stock who acted solely for the principal promoter and for whom part of the purchase price of land purchased by the principal promoter was withheld as "commissions" was held a promoter. In the Matter of Continental Distillers and Importers Corp., 1 S.E.C. 54, 1935.

(C) A $1,800,000 apartment-hotel was to be financed by the sale of "Amortization Notes", a share of stock being given free with each Note. 25% of the total authorized stock, denominated as "CP Sponsor Shares", was to be sold to the Highland Apartment Management Co., which was owned by the four promoters of the enterprise. The Commission issued a stop order suspending the effectiveness of the registration statement. As to the interests of the promoters, the prospectus was found to be deficient in failing to reveal: (1) that the Management Co. was enabled to purchase the 6,000 Sponsor Shares for $600, thus giving the promoters special treatment; (2) that the provision giving the X Construction Co. (owned by one of the promoters) a fixed fee for acting as general contractor did not explain that the X Co. was also empowered to act as sub-contractor; (3) that the statement in the prospectus, "There has been no amount paid and there is no amount intended to be

paid to any promoter, as such", conflicted with other widely separated provisions and made it difficult for an investor to understand how much interest the promoters were in fact to receive; (4) that the provision giving one-eighth of the "available net income" to the Management Co. as a fiscal fee after the completion of the building meant "net income" not in the commonly used or accountant's meaning since there was to be no reserve set aside out of income for depreciation. In the Matter of West Park Apartments Corp., 3 S.E.C. 900, 1938.

(D) In a new corporation, on the other hand, the share of the promoter is of special interest and significance as the percentage of dilution of the stock for promotional payments is apt to be great. Form A-I is designed to force disclosure of the promotion process so that the investor may know what he is paying for this type of service. The form when answered properly will bring out the names and addresses of the promoters, the stock interest, whether beneficial or of record, payments to promoters and the nature of the consideration given therefor, a statement of the intention of such persons with respect to subscription to additional stock and the prices at which such subscriptions will be executed, and details of any property purchases already made from promoters and any property purchases to be made by use of the proceeds of the issue registered. The Commission has, in many instances, compelled the identification of certain payments ostensibly going to an individual not named as promoter, or disguised as a payment for tangible assets, as promotional payments. Administration has made these requirements of disclosure not merely formal. A superficial statement of what has been given and what has been received is not enough. The real character of the promotional operation must be clearly presented. This insistence on reality is present both in the cases decided without opinions as well as those in which an opinion has been published. The opinions, however, make clear the basis for the other rulings.

To date, the Commission has made no definitive statement of the type of participation or activity which will render one a promoter. The accretion of its rulings in this connection indicates quite definitely, however, that its concept of "promoter" does not vary significantly from the common law doctrine. It may be said without attempting to predict possible extensions of the rule that one who participates actively in bringing about the formation of a corporation or one who participates actively in the launching of the enterprise after its formation will be deemed to be a promoter. MacChesney and O'Brien, Full Disclosure Under the Securities Act, 1937, 4 Law and Contemp. Problems, 133, 136.

(E) Rule 142 was adopted in recognition of the value of secondary capital in facilitating the flow of investment funds into industry, and of the fact that the owners of such secondary capital cannot practicably perform the duty of thorough investigation and analysis imposed by the Act of the underwriter proper. The rule in no way limits the responsibility of the underwriter who actually serves as a conduit for the distribution of securities to the public, or of the underwriter who for a commission agrees with the issuer to purchase what the issuer is unable to sell to the public—thereby furnishing to the issuer the insurance without which the distribution would probably not be undertaken. The purpose of the rule is merely to make clear, what has admittedly been the subject of some debate in the past, that a person who does no more than agree with an underwriter to take over some or all of the undistributed portion of the issue, and who purchases for investment any securities which his commitment thus obliges him to take up, does not thereby subject himself to liability as an underwriter of the securities of the issue actually distributed to the public.

In considering the application of the rule to particular situations, it should be appreciated that it applies only to persons whose connection with a distribution is essentially non-distributive in character. Any person enjoying substantial relationships with the issuer or underwriter, or engaging in the performance of any substantial functions in the organization or management of the distribution, would be outside the scope of the rule. Basically, the rule is designed to cover the con-

ditional purchaser who, in spite of the conditional nature of his contract, is primarily interested in securing a portion of the issue for investment, and finds his incentive not in a commission based on the size of the issue or other similar factors, but in the investment advantage afforded by a discount from the public offering price. Disproportionate commissions or service fees would raise a serious doubt whether the functions of the person concerned were in fact confined as prescribed in the rule, for such disproportionate commissions or fees would tend strongly to show that such person was primarily interested as an "underwriter" in the distribution.

Some question will undoubtedly be raised as to the meaning of the term "purchases * * * for investment", as used in the rule. The application of this term is of course to be ascertained in any given case by reference to the intention of the purchaser at the time of purchase. What his intention was at that time is a question of fact.

Although it is not impossible to conceive of a situation in which a person who had purchased securities for investment changed his mind in good faith on the next day, and proceeded to dispose of the securities, it must nevertheless be remembered that a state of mind can ordinarily be ascertained only by weighing evidentiary factors, and that a person's actions may be of far greater evidentiary significance than his statements as throwing light on what his state of mind was at a given time. Thus, self-serving statements that a particular purchase was made for investment would carry very little weight in the face of more concrete facts and circumstances inconsistent with such an intention.

Most prominent among the relevant evidentiary factors would undoubtedly be the length of time elapsing between the acquisition of the securities and their proposed resale. Although retention of the securities for any given length of time would in no event be conclusive, it is obvious that the longer they were held the easier it would be to maintain that they had originally been purchased for investment; and it is my opinion that if they were retained for a period as long as a year that fact would be sufficient, if not contradicted by other evidence to create a strong inference that they had been purchased for investment. However, such an inference would be rebuttable; for example, it would fall in the face of evidence of a pre-arranged scheme to effect a distribution at the end of the year.

Another factor which may be of considerable importance is the character of the regular business of the person who seeks to come within the rule. Thus, I have little doubt that insurance and investment companies not ordinarily engaged in the business of dealing in securities or underwriting distributions could quite readily sustain the burden of proof that they had purchased for investment. On the other hand, in the case of a securities dealer or an investment banking house, the nature of the business ordinarily carried on would create an extremely strong presumption of purchase for resale. It is perhaps possible that a person engaged in the investment banking business or in the securities business might, under some circumstances, come within the provisions of the rule; but in order to reach this result it would be necessary to establish by the clearest kind of evidence that the scope and character of the person's business were consistent with the purchase of large blocks of securities for investment rather than with a view to distribution. Opinion of General Counsel of the Commission (Chester T. Lane), Securities Act Rel. No. 1862, Dec. 13, 1938 (I C.C.H., Fed.Sec.Law Serv., ¶ 2168.18).

In the Matter of REITER-FOSTER OIL CORP.

6 S.E.C. 1028, 1940.

This is a proceeding under Section 8 (d) of the Securities Act of 1933, 15 U.S.C.A. § 77h(d), to determine whether a stop order should

issue to suspend the effectiveness of a registration statement filed June 29, 1936, on Form A-1, by Reiter-Foster Oil Corporation. The registration statement covers 549,850 shares of common stock, which comprise all of the authorized unissued stock of the corporation.[31] * * *

The registrant was organized under the laws of Delaware in 1924 for the purpose *(inter alia)* of producing and marketing crude oil and gas and dealing in leases and royalties. In its early years it was a substantial company, with assets of nearly $2,000,000; but its properties continually declined in value until, as of March 30, 1937, they were carried on the balance sheet of the corporation at $255,203.59.

On December 12, 1931, a mortgage on part of the registrant's producing properties (hereinafter referred to as the Gibson-Bailey trust) in favor of certain creditors was given to secure an aggregate indebtedness of $250,000. This debt, reduced to judgment, was scaled to $61,947 by agreement of the parties on condition that it would be paid on or before October 27, 1936. These creditors constantly pressed the registrant to discharge that indebtedness and threatened to enforce their lien unless payment were made. That threat led to the present financing.

On December 22, 1934, practically all of the producing properties remaining to the registrant were placed in another trust (under an instrument referred to hereinafter as the Ache trust). Its purpose was to secure claims aggregating $13,584.61 in favor of persons connected with the management of the registrant for services and salaries, as well as "all future indebtedness" due these persons. The original cost of these properties was $191,839.49. The trust agreement provided that if the claims secured thereby were not paid within six months after the date of the instrument, absolute title should vest in Paul S. Ache, for the benefit of the claimants thereunder.

The registrant, for the five years preceding the filing of the registration statement, was relatively dormant. Such revenues as it derived during this period were paid to creditors under both trusts.

In the latter part of 1935, the management of the registrant, in an effort to prevent the loss of its properties to creditors, designated Paul S. Ache to procure financing for it. On February 27, 1936, Ache received a letter from Walter Clifford evidencing an interest in acquiring 200,000 shares of the registrant's stock for a "client."

Ache investigated Clifford's financial responsibility and was told that he was without funds, but apparently energetic and capable of handling any commitments he might make. Thereafter, an underwriting agreement was entered into between the registrant and Clifford which provided, in substance, that within thirty days after notice that the registration statement had become effective and the stock had been listed for trading on the New York Curb Exchange, Clifford would purchase for cash 100,000 shares at 50 cents per share, and that "upon payment of the purchase price thereof to wit, $50,000," the underwriter agreed at certain designated times "to purchase and pay for" an additional

31 The total authorized capital of the corporation is 1,000,000 shares of common stock.

100,000 shares at 50 cents per share, and another 100,000 shares at 62½ cents per share. Provision was made for a series of options on the remaining 249,850 registered shares, which could be exercised at graduated prices.[32] The agreement provided that the underwriter would offer 200,000 shares at 65 cents per share to existing stockholders "who shall have 30 days from the date of mailing the offer within which to subscribe for stock." That portion of the 200,000 shares not subscribed for by stockholders plus the balance of the shares included in the underwriting were to be "offered to the public from time to time at the market price as it exists from day to day on the New York Curb Exchange." If the underwriter performed all commitments and exercised all options, the total net proceeds to the registrant would have been $337,-387.50.

On August 17, 1936, the registrant applied to the New York Curb Exchange for listing of the underwritten shares. The Curb, however, on September 2, 1936, refused to list until $162,500 had been deposited by Clifford to meet his commitments. Unable to deposit cash, Clifford, with the knowledge of the registrant, printed and sold temporary certificates which provided that they might be exchanged for listed shares in the event that the stock was listed.[33] During the period of the Clifford underwriting, temporary certificates purporting to represent approximately 60,000 shares were sold.[34]

Clifford's manifest inability to provide the money necessary to allay creditors led to the intervention of a new group of underwriters,—the Hiltz & Company and Harry K. Greenfield group,—who on February 24, 1937, took an assignment of Clifford's underwriting contract.[35] At the instance of the new underwriters, the Curb lessened its deposit requirements, and cash was provided to enable the registrant to pay the Gibson-Bailey creditors. Upon such payment the properties mortgaged under the Gibson-Bailey trust were returned to the registrant.

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[32] The following is illustrative of the option provisions:

"(3) That within the next sixty (60) days thereafter, which would be two hundred ten (210) days after the notice as originally provided for, the underwriter agrees to purchase and pay for one hundred thousand (100,000), additional shares of said stock, at the price of sixty-two and one-half cents (62½ cents) per share, if at any time within said two hundred and ten (210) days Reiter-Foster Oil Corporation stock shall sell on the New York Curb Exchange at a price of One Dollar ($1.00) per share, or better, but the underwriter shall have an option in any event to purchase said additional 100,000 shares within said two hundred and ten (210) days at the option price of sixty-two and one-half cents (62½ cents)."

A similar arrangement was made as to the acquisition of the remaining 149,850 shares at 75 cents if the stock sold on the New York Curb Exchange at $1.12½ per share.

[33] No registration of these certificates was attempted.

[34] Upon subsequent listing of the stock, the vast majority of these certificates were exchanged for listed certificates. Temporary certificates representing a small amount of shares remained outstanding at the time of the hearing, although an offer for exchange had been promulgated.

[35] The substitution of Hiltz & Company and Harry K. Greenfield as underwriters of the registrant is reflected in the post-effective amendments of March 30, and April 12, 1937.

The underwriting agreement was modified to provide for a firm commitment on 145,000 shares at 50 cents per share, and an option on 99,863 shares at 62½ cents per share. The contract of assignment provided that Clifford would receive 8 cents per share on all shares sold by Hiltz & Company and Harry K. Greenfield.

The offering to the public by the new underwriters was made through the medium of a revised prospectus. We shall hereinafter refer to that prospectus as the Hiltz & Company prospectus. The prospectus employed by Clifford will be referred to as the Clifford prospectus.

The Alleged Deficiencies

For convenience, the alleged deficiencies will be considered according to subject matter rather than in the order of the items in the registration statement.

First. Item 31 calls for the name and address of each underwriter of the registered issue. The registrant's amended answer to this item is that "Walter Clifford was the former underwriter," and that he had assigned to Hiltz & Company, Inc., and Harry K. Greenfield all of his rights to underwrite the stock, and that the latter are the underwriters with respect to an aggregate of 244,863 shares of the registered stock. Item 35 requires a list of the persons or classes of persons (other than underwriters as such) to whom securities are proposed to be offered at prices varying from the price at which the securities are proposed to be offered to the general public, naming such persons or specifying each class, and the price to each. The amended answer to this item is that 55,137 shares were sold to Clifford, "a former underwriter," at 50 cents per share, and that "no persons or classes of persons, other than Hiltz & Company, Inc., and Harry K. Greenfield, the underwriters, are to be offered any part of the 244,863 shares of the capital stock of the registrant * * * at prices varying from the price at which the securities are proposed to be offered to the general public. * * *" Item 36 calls for a detailed list showing, in respect of each and every underwriter of the registered issue, the amount underwritten and all commissions or discounts to be paid, directly or indirectly, by the issuer in respect of the sale of the security to be offered. The amended answer to that item summarizes the terms of the registrant's prior agreement with Clifford, and the new agreement between Hiltz & Company, Inc., Greenfield, the registrant, and Clifford relative to underwriting the registered shares.

Counsel to the Commission charges that the answers to items 31, 35, and 36 of the registration statement as originally effective, and the post-effective amendments of March 30, and April 12, 1937, to these items, the Clifford prospectus, and the Hiltz & Company prospectus are materially deficient for failure to disclose required information relative to certain individuals alleged to be underwriters.

An underwriter, as defined in the Act, is one "who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission."

The term "underwriter," it may be noted, is broadly defined. It includes one who purchases an issue outright with the view to selling that issue to the public, as well as one who, for a commission, guarantees that an issue will be disposed of at a certain price. It includes the so-called "underwriters of the underwriter," a group which, for a commission, agrees to take over all or a portion of the underwriting risk assumed by the initial underwriter. It includes persons who participate, or have a direct or indirect participation, in any underwriting transaction. One may be an underwriter within the meaning of the Act even though he is not a formal party to the underwriting contract. See H.R. Rep.No.85, 73d Cong., 1st Sess., May 4, 1933; H.R.Rep.No.152, 73d Cong., 1st Sess., May 20, 1933.

The persons concerning whom required information was allegedly omitted from the registration statement are Paul S. Ache, Morris C. Rosenbaum, William E. Housel, Howard J. O'Connor, and Victor B. Zeman. We turn to a consideration of whether each of those persons is an underwriter within the statutory definition.[36]

Paul S. Ache. Ache, who had no official connection with the registrant, was designated to procure financing for it. For "his services in securing the contract with Walter Clifford * * * and in bringing about the refinancing of the company," the Board of Directors of the registrant, on March 23, 1936, voted to award Ache "a sum equal to ten per cent (10%) of all sums paid into the company by Clifford & Company, or Walter Clifford, under said contract. * * *"

Ache actively participated in the distribution of the underwritten securities. He touted those securities in an effort to induce purchases. He contacted security holders to persuade them to refrain from selling their securities, because such sales might render the distribution more difficult. He suggested to Clifford the names of persons whom he termed "great boosters when you are making a market," and supplied the names of many dealers who might participate in the distribution. He assisted in obtaining extensions of the Gibson-Bailey mortgage, without which financing by the registrant would have been impossible. He was instrumental in obtaining a loan of 5,000 shares of stock from one Warwick M. Downing to Clifford[37] which were sold and the proceeds employed to pay certain expenses connected with the underwriting. He constantly supplied information which was needed or desired by Clifford concerning the registrant.

Ache's participation in the distribution brought him squarely within the statutory definition of an underwriter. The award by the registrant of 10% of the amount paid into the company by Clifford may explain Ache's conduct. Since the amount of his compensation depended upon the amount paid into the company by Clifford, it was to Ache's pecuniary interest to stimulate buying power and to facilitate the dis-

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[36] We have held on numerous occasions that it is highly important that investors be adequately and accurately informed of arrangements for the underwriting and distribution of registered securities. See e. g., Bering Straits Tin Mines, 2 S.E.C. 486, 1937; Sweet's Steel Company, 4 S.E.C. 589, 1939.

[37] The registrant promised to return these 5,000 shares, or their stated value, which amounted to $3,750.

tribution of the registrant's securities. But even if this monetary incentive were not present, we would be constrained to hold that Ache was an underwriter.

Morris C. Rosenbaum. Clifford's attempt to underwrite the registrant's stock, in view of his admittedly impecunious condition, is explained by the fact that Rosenbaum had represented to him that Rosenbaum could find purchasers for the shares and that he would "contact all the dealers he knew * * * and help me (Clifford) on the stock." Rosenbaum attended conferences between Ache and Clifford relative to arranging the terms of the underwriting. At these initial conferences, market operations in the stock were discussed and Rosenbaum related "what he could do" in that regard.

There existed between Rosenbaum and Clifford an agreement that "we are to share equally (50-50) in all monies received by us, over and above the price we pay for the stock of the Reiter-Foster Oil Company." Further, Rosenbaum shared the override of 8 cents per share given to Clifford as consideration for his subsequent assignment of the underwriting to the Hiltz-Greenfield group. Frequent mention is made by Clifford and others in their correspondence of Clifford's "associates" or "associate." Rosenbaum was revealed as the associate.

Counsel for the registrant urges that Rosenbaum was merely a "finder," and that the profit-sharing arrangement between him and Clifford was entered into because Clifford was unable to pay a flat sum. The record shows, however, that Rosenbaum was to take, and in fact did take, a far more active part in the proposed distribution than that of a mere "finder." [38] He induced a Mr. Sedlis of Boston to purchase 8,400 shares of the registrant's stock on the representation that he could double or triple his money. He was instrumental in obtaining the sale of 1,200 shares through another dealer. He participated in some of the conferences between Clifford and Housel which finally resulted in the assignment of the underwriting contract to Housel,[39] under which Clifford and Rosenbaum were to retain an override of 5 cents per share of each share sold. He frequently inquired of Housel as to sales, and urged greater activity in the distribution of the shares. He made arrangements for the sale, through a broker, of 6,400 shares of treasury stock of the registrant in order to provide funds for the payment of expenses of the financing program.

The existence of his agreement to share the proceeds of the underwriting provided Rosenbaum with an impulse to aid the distribution of the securities. And he did, in fact, actively participate in the distribution. He was, therefore, an underwriter.

William E. Housel. On December 14, 1936, Clifford and Housel entered into an agreement whereby Housel was constituted "exclusive selling agent, with the power to appoint subagents, dealers, and sell wholesale and retail." The agreement obligated Housel to take down

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[38] While an agreement to share in the profits of an underwriting does not, of itself, make the profit-sharer an underwriter, it is to be taken into account with other evidence. Puget Sound Distillery Inc., 3 S.E.C. 357, 1938.

[39] The assignment to Housel is more fully considered later.

by December 20, 1936 [40] a sufficient amount of stock to yield at least $7,000. Except for an override of 5 cents per share, Housel was to retain the proceeds from all sales of the underwritten securities. This agreement was superseded by a new contract, dated December 22, 1936, between Clifford and Housel. The new contract bore substantially the same terms as the old contract, except that it provided for a minimum take-down of 20,000 shares per month by Housel from Clifford.

Upon being advised that the contract with Housel would establish Housel as an underwriter, Clifford purported, by letter, on January 15, 1937, to cancel it. Immediately thereafter however, Clifford informed Housel that the letter was a formality and did not affect their arrangement.

Prior to and after the purported cancellation of this contract, Housel actively participated in the distribution of the stock. In aid of the distribution, he had been given a list of the registrant's stockholders by Clifford's secretary, with the consent of Lyons, president of the registrant at that time. He used that list to circularize stockholders, urging them to purchase stock at 65 cents per share. Of the 55,137 shares sold during the entire period of the "Clifford" underwriting, Housel was responsible for the sale of 26,500 shares. In one case he induced the purchase of 300 shares on the representation that the "stock could be disposed of within four months at between $2.50 and $3 per share."

Housel also made *purchases* on the Curb in an effort, as alleged, to arouse interest in the stock through an indication on the ticker tape of activity in the stock.[41] Together with Clifford, he had an understanding with Howard J. O'Connor that O'Connor was to make daily purchases on the Curb which would be reflected on the ticker tape. When O'Connor failed in this task, Housel himself stepped in to put "a print on the tape."[42]

Housel's sales, his interest and participation in the market operations in the stock, and his arrangement with Clifford, make it clear that he was an underwriter within the meaning of Section 2(11) of the Act, 15 U.S.C.A. § 77b(11).[43]

Howard J. O'Connor.[44] O'Connor was the "market man" in the dis-

40 This was the date of termination of an extension granted by the creditors under the Gibson-Bailey mortgage for payment of the underlying debt.

41 This conduct will be discussed in detail in a later portion of this opinion.

42 Housel explained this conduct on the ground that, "We had orders and there had to be a price established, and the only way to have a price established was by having a print on the tape." Housel was referring to the provision of the underwriting agreement between Clifford and the registrant to the effect that the shares were to be sold at the last recorded sales price on the New York Curb Exchange, or at the last reported closing sales price on such Exchange. It is obvious, however, that whether or not a sale takes place on any day, the stock maintains the price established by the last transaction of a previous day.

43 The record leaves no doubt that the registrant was aware of Housel's participation. In fact, the record contains correspondence between the president of the registrant and Clifford, prior to the date the post-effective amendments were filed, noting the existence of Housel's participation. Housel was certain that Kahn, attorney for the registrant, was aware of his participation.

44 Housel assigned his agreement with Clifford to O'Connor and Kauder & Company on December 14, 1936. The results under that assignment were unsatisfactory, and that assignment was apparently nullified under the new contract of December 22, 1936, between Clifford and Housel.

tribution during the "Clifford" underwriting. It was his job to keep a print on the tape daily, as well as sell stock in the course of the distribution. He managed not only to keep a print on the tape,[45] but, on several occasions, by purchase orders at the close of the market scaled to the *asked* price, to raise the price of the stock. O'Connor admitted that care of the market was discussed in preliminary conferences with Housel.[46]

Clifford denied that he knew of the arrangement between Housel and O'Connor. However, Housel testified that it was agreed among Clifford, Housel and O'Connor that O'Connor was to maintain a print on the tape. O'Connor testified that Clifford complained to him several times that he had not induced sufficient activity on the market. Furthermore, Housel wrote to Clifford requesting authorizations to deliver shares to O'Connor to cover deliveries on O'Connor's sales.[47]

Counsel for the registrant argues that O'Connor was merely "a dealer or a salesman working for and on behalf of Housel" and was not an underwriter. The evidence shows that O'Connor's functions lay far beyond those of a dealer or salesman. We find him to be an underwriter. Simple vigilance in making disclosures to investors as to the manner in which the stock was being distributed required that the information disclosed in the registration statement be amplified to include O'Connor's participation.

Victor B. Zeman. In December, 1936, or January, 1937, Zeman was requested by his brother-in-law, Kenton, then vice president of the registrant, to assist in raising the capital that had not been forthcoming under the Clifford underwriting. Thereafter, Zeman undertook to obtain a successor to Clifford. Through his efforts, the Clifford underwriting contract was assigned to Hiltz & Company and Greenfield.[48]

In an effort to procure listing of the stock, Zeman, who then was an employee of Ferd. Loeb & Co.[49] in charge of all customers' men, appeared before the Listing Committee of the New York Curb Exchange and made various statements which were subsequently found to be "seriously misleading in various respects.[50] Once the distribution pro-

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[45] At least four of the purchases made on the Curb by O'Connor were the only transactions of the day.

[46] "When we first discussed this thing, I told Housel, 'Let me take care of this, whoever is in, let us take care of that market.' "

[47] Kahn, the attorney procured by Rosenbaum to prepare the registration statement, testified that he was unaware of O'Connor's interest. However, he did have knowledge that O'Connor was making sales and wrote to Clifford asking for a statement of O'Connor's interest. Clifford replied that it was none of Kahn's business.

[48] Zeman and Greenfield had worked together in financial ventures in the past. All the stock taken by Greenfield pursuant to the present underwriting went into his account at Ferd. Loeb & Co.

[49] Ferd. Loeb & Co. was a member of the New York Curb Exchange. It took a commission on all shares taken down by Greenfield and brought into his account at Ferd. Loeb & Co. That firm likewise benefitted by obtaining commissions from purchases and sales on the New York Curb Exchange by the underwriters and their associates.

[50] For his conduct before the Listing Committee, Zeman was called before the Committee on Membership of the New York Curb Exchange on March 23, 1937, and was reprimanded and warned that a repetition of his conduct would bring about "a much more serious form of punishment."

gram of the new underwriting group was inaugurated, Zeman's efforts to insure the success of the undertaking were unremitting.

Zeman actively participated in the distribution of the stock. David Lewis, a customer of Ferd. Loeb & Co., whose account was handled by Zeman and Harold Loeb, a partner, testified that he purchased 1,000 shares of the registrant's stock on the representation by Zeman that the stock was in for a rise. Zeman endeavored to interest the Proucul Realty Company in distributing Reiter-Foster stock in upper New York. The Proucul Realty Company rejected that proposition. It appears, however, that the Proucul Realty Company had previously advanced $20,000 to Greenfield upon pledge of 40,000 shares of Reiter-Foster stock. Payments on the loan lagged, and the Proucul Realty Company threatened to dispose of the pledged securities on the market. Disposition of those shares would have depressed the market price, and disrupted the proposed distribution. Zeman participated in negotiations which led to the payment of the loan to Proucul Realty Company, thereby averting the threatened dumping of stock on the market.

In the course of the Hiltz-Greenfield underwriting, over $2,000 was expended in California, ostensibly to "blue sky" the shares in that state. Frank Ware, one of the partners of Hiltz & Company, wired to Hiltz in California: "Zeeman (sic) agreeable to expenditure of $2,000. * * *" This was explained by Hiltz on the ground that "We sort of took it for granted that * * * either Greenfield was representing Zeman or Zeman was representing Greenfield, or they were working together or something of that kind because one would deliver a message. * * * Zeman would come in and say 'Greenfield said so and so, or such and such.' "

Zeman was active in matters relating to the management of the registrant, which might affect the underwriters' ability to distribute the registered shares. It appears that the question of procuring a new president satisfactory to the new underwriters was discussed with Zeman. After the new president, Campbell, was chosen, he was instructed (although he declined to abide by the instruction) to report to Zeman.[51] Moreover, Zeman was consulted on one occasion as to the price at which producing properties might be acquired for the registrant in exchange for underwritten shares.

Counsel for the registrant contends that Zeman's activity can be explained on the ground that he "was attempting to aid in making successful a venture that he had persuaded others to enter into."[52] But

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51 While the underwriters were pressing Campbell, president of the registrant, for "good news" from the oil fields to aid in moving the stock up, Ware, partner in Hiltz & Company, wrote a congratulatory letter to Campbell on the commencement of drilling: "I was delighted indeed to back your judgment in this new undertaking. Zeman felt the same way."

52 Apart from the facts set forth in the text, it appears that a portion of the funds employed by Greenfield to meet his underwriting commitment was traceable to various brokerage accounts, in some of which Zeman had a 50% interest. Zeman had several judgments outstanding against him. It may be, therefore, that he wished to conceal his participation in any venture which might result in a profit. Greenfield denied, however, that Zeman had a surviving interest in the funds which Greenfield removed.

000 shares might be obtained, on terms later to be arranged. The purpose was publicly to distribute the stock. From February 13 to May 6, 1936, defendants exercised the option to the extent of 6,200 shares, which they sold through the use of the mails and of the facilities of interstate commerce, both over-the-counter and on the New York Stock Exchange. Park & Tilford stock has not been registered under the 1933 Securities Act.

Defendants contend that their transactions were exempt under Sections 3(a) and 4 of the Act. Neither exemption applies to "underwriters" as defined in Section 2 (11). David A. Schulte controls both Park & Tilford, Inc., and the 1931 Corporation through stock ownership. As under the statutory definitions, 1931 Corporation is an "issuer" because under common control with the issuer, Park & Tilford, Inc., and defendants as purchasers of the stock from 1931 Corporation with a view to its distribution, are "underwriters," the transactions, as alleged in pleadings and affidavits, show violations of section 5(a).

Defendants, however, here, too, contend that there is no such danger of future violations as to justify a preliminary injunction, inasmuch as they ceased all activity in the stock on May 6, 1936, and assert that they do not contemplate any resumption thereof. Here, too, these transactions like those in General Bronze stock, were not discontinued until after the commission had begun its investigation, and there are still perhaps available to the defendants 3,800 shares under the terms of the option, as well as the possibility of obtaining a further 10,000 shares. While the situation offers a strong temptation to resume operations as the option for the 3,800 shares is at a fixed price far below the present market quotations, and while there is no such conflict as to the facts and law as in the General Bronze deals, nevertheless, I am not persuaded that there is such an imminent danger of statutory violations before the final hearing, that a temporary injunction should at this time be granted against such unlawful dealings in Park & Tilford stock.

While, therefore, the motion must be denied at this time as to such alleged unlawful dealings in General Bronze, in Park & Tilford, or as prayed for, in other stocks, it will be without prejudice to its renewal on a showing of any later unlawful transactions by defendants in any stocks. In the circumstances, an application may well be made for a preference on the trial calendar.

In the Matter of IRA HAUPT & COMPANY.

Exchange Act Release No. 3845, August 21, 1946.

Findings and Opinion of the Commission.

This proceeding was instituted under Sections 15(b) and 15A (1) (2) of the Securities Exchange Act of 1934 * * * to determine whether Ira Haupt & Co. ("Respondent") willfully violated Section 5 (a) of the Securities Act of 1933 and, if so, whether the revocation of its registration as a broker-dealer and its explusion or suspension from membership in the National Association of Securities Dealers,

Inc. ("NASD"), a registered securities association, would be in the public interest.

The alleged violation of Section 5(a) is based on Respondent's sale, for the accounts of David A. Schulte, a controlled corporation of Schulte's and David A. Schulte Trust (sometimes hereinafter referred to collectively as the "Schulte interests"), of approximately 93,000 shares of the common stock of Park & Tilford, Inc. during the period November 1, 1943, to June 1, 1944. It is conceded that the Schulte interests were in control of Park & Tilford during this period, that the sales were effected by use of the mails and instrumentalities of interstate commerce, and that the stock was not covered by a registration statement under the Securities Act. * * *

After appropriate notice a hearing was held before a trial examiner. At the hearing a stipulation of facts was submitted in lieu of testimony. A trial examiner's report was waived, briefs and reply briefs were filed, and we heard argument. * * *

Before discussing the particular problems of statutory interpretation which have been raised, it will be helpful to consider the general purposes and policy of the Securities Act.

The Securities Act.

The general policy of the Securities Act is to provide for "full disclosure of every essentially important element" attending a distribution of securities. This policy is equally applicable to the distribution of a new issue and to a redistribution of outstanding securities which "takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering." The disclosure required takes the form of a registration statement filed with this Commission and a prospectus, summarizing the information in the registration statement, which must be furnished to prospective investors. Unless and until these requirements are fulfilled, the mails and the channels of interstate commerce are closed to the distribution or redistribution of an issue. Thus Section 5(a) prohibits the use of the mails or any means of interstate commerce to sell, or to deliver after sale, any unregistered security and Section 5(b) prohibits any such transaction with respect to registered securities unless a prospectus containing the required information is used.

Sections 3 and 4 of the Act provide certain specific exemptions from these requirements. But these exemptions are plainly designed to do no more than mark out specific situations in which Congress considered the protection afforded by registration either unnecessary, unduly burdensome, or an inappropriate subject for Federal legislation. The general pattern of the Act—a sweeping prohibition, subject to a limited number of carefully defined exemptions—considered together with the nature and particularity of the exemptions themselves emphasizes rather than obscures the basic purpose of the Act to protect investors and stresses the generality of its intended application. In this setting, it is clear that the exemptions must be strictly construed and that the

claimant of an exemption has the burden of showing that he falls within the terms of the exemption he claims.[54]

The Issues Involved.

It is conceded that Respondent's transactions in Park & Tilford stock for the account of the Schulte interests constitute a violation of Section 5(a) unless an exemption was applicable to such transactions. Respondent contends that one or more of the following exemptions was applicable: Section 3(a) (1) which applies to

Any security which, prior to * * * the enactment of this title, has been sold or disposed of by the issuer * * * but this exemption shall not apply to any new offering of any such security by an issuer or underwriter * * *;

The third clause of Section 4(1) which exempts

> transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except transactions within one year after the first date upon which the security was bona fide offered to the public * * * by or through an underwriter * * * and except transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities * * * by or through an underwriter;

and Section 4(2) which exempts

> Brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders.

The applicability of the foregoing exemptions involves the following sub-issues:

(1) Was Respondent an "underwriter" as that term is defined in Section 2 (11)?

(2) Did Respondent's transactions constitute a new offering of Park & Tilford stock by an underwriter?

(3) Is the brokerage exemption of Section 4 (2) available to an underwriter who effects a distribution of an issue for the account of a controlling stockholder through the mechanism of a stock exchange? * * *

1. Was Respondent an "Underwriter"?

Section 2 (11) defines an "underwriter" as

> any person who * * * sells for an issuer in connection with, the distribution of any security * * * As used in this paragraph the term "issuer" shall include * * * any person * * * controlling * * * the issuer * * *

The purpose of the last sentence of this definition is to require registration in connection with secondary distributions through under-

[54] Securities and Exchange Commission v. Sunbeam Gold Mines Company, 95 F. 2d 699 (C.C.A.9, 1938).

writers by controlling stockholders. This purpose clearly appears in the House Report on the Bill which states that it was intended:

> to bring within the provisions of the bill redistribution whether of outstanding issues or issues sold subsequently to the enactment of the bill. All the outstanding stock of a particular corporation may be owned by one individual or a select group of individuals. At some future date they may wish to dispose of their holdings and to make an offer of this stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities. Wherever such a redistribution reaches significant proportions, the distributor would be in the position of controlling the issuer and thus able to furnish the information demanded by the bill. This being so, the distributor is treated as equivalent to the original issuer and, if he seeks to dispose of the issue through a public offering, he becomes subject to the act.[55]

It is conceded that the Schulte interests controlled Park & Tilford and that Respondent was, therefore, "selling for" a person in control of the issuer. However, Respondent denies that these sales were effected "in connection with the distribution of any security." It asserts that at no time did it intend, nor was it aware that Schulte intended, a distribution of a large block of stock. It emphasizes that, in connection with the sales by which Schulte disposed of approximately 52-000 shares over a period of six months, each order was entered by Schulte to maintain an orderly market and was limited to 200 or 300 shares at a specific price; that the authority to sell 73,000 shares for the Trust was dependent upon a market price of at least 80; that the total amount which would be sold was never fixed or ascertained, and that consequently it did not intend to sell in connection with a distribution.

"Distribution" is not defined in the Act. It has been held, however, to comprise "the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public." [56] In this case, the stipulated facts show that Schulte, owning in excess of 50,000 shares, had formulated a plan to sell his stock over the Exchange in 200 share blocks "at 59 and every quarter up" and that the Trust, holding 165,000 shares, specifically authorized the sale over the Exchange of 73,000 shares "at $80 per share or better." A total of 93,000 shares was in fact sold by Respondent for the account of the Schulte interests pursuant to these authorizations. We think these facts clearly fall within the above quoted definition and constitute a "distribution." We find no validity in the argument that a predetermination of the precise number of shares which are to be publicly dispersed is an essential element of a distribution. Nor do we think that a "distribution" loses its character as such merely because the extent of the offering may

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[55] Report of Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess., H.R.Report No. 85 at pp. 13-14.

[56] Oklahoma-Texas Trust, 2 S.E.C. 764, 769 (1937), aff'd 100 F.2d 888 (C.C.A.10, 1939).

depend on certain conditions such as the market price. Indeed, in the usual case of an offering at a price, there is never any certainty that all or any specified part of the issue will be sold. And where part of an issue is outstanding, the extent of a new offering is almost always directly related to variations in the market price. Such offerings are not any less a "distribution" merely because their precise extent cannot be predetermined.

Nor can we accept Respondent's claim that it was not aware of the distribution intended by the Schulte interests. The record shows that Respondent was informed of the extent of Schulte's holdings and of his plan to sell 200 share blocks "at 59 and every quarter up." And in the case of the Trust, Respondent received its express authorization to sell up to 73,000 shares "at $80 per share or better" and affirmatively undertook to sell this block subject only to the contingency that the market reach the specified figure. Once sales were made under these authorizations we believe the foregoing facts, in themselves, show that Respondent was an underwriter selling for the Schulte interests in connection with the distribution of Park & Tilford stock. But even if we assume that the nature of the contingency and Respondent's belief as to the possibility of its fulfillment are relevant in determining the existence of a "distribution" and Respondent's status, the facts in this case show that Respondent had every reason to believe that the distribution would in fact take place.

At the time of the first discussion with Schulte, Respondent knew that the Schulte orders were to be placed after an announcement of a possible liquor dividend which was expected to create greatly increased market activity and a sharp rise in price and that the stated purpose of these orders was "to have an orderly market." Moreover, the fact that the public announcement of the possible liquor dividend was made much in advance of the date the dividend was actually declared, together with Schulte's statement as to the probable effect of the general announcement, was additional evidence that Schulte intended to distribute his holdings to the public at rising prices. The only reasonable conclusion that could have been reached by Respondent was that it was intended that a large block would be sold. This is, of course, what actually happened. In the two days after the general announcement of the liquor plan, the stock advanced from 57⅝ to 70⅞ and Respondent sold 15,700 shares for Schulte. And from December 1943 through May 1944 Respondent sold, in addition, approximately 38,000 shares for Schulte and the 1924 Corporation.

The authorization to sell 50,000 shares for the Trust was received by Respondent on March 7, 1944. At that time Respondent had already sold in excess of 45,000 shares for Schulte. Moreover, when Respondent sold 8,000 shares for the Trust in 8 trading days, its authorization from the Trust was increased to 73,000 shares. Respondent's actual sales for the Trust totalled approximately 50,000 shares in March, April and May 1944.

We conclude from the foregoing facts that Respondent was selling for the Schulte interests, controlling stockholders of Park & Tilford,

in connection with the distribution of their holdings in the stock and was, therefore, an "underwriter" within the meaning of the Act.

2. Did Respondent's Transactions Constitute a New Offering of Park & Tilford Stock?

The exemption of Section 3(a) (1) does not apply to "any new offering * * * by an * * * underwriter" and the exemption in the third clause of Section 4 (1) is not available to transactions in a security within one year after the first date upon which such security is "bona fide offered to the public * * * by or through an underwriter." The applicability of these exemptions to Respondent's transactions depends, therefore, on whether these transactions were part of a new offering to the public by or through an underwriter. We have already found that Respondent acted as an underwriter in connection with the distribution of the Park & Tilford stock to the public. We think it clear that, in the context of this case, the "distribution" of a controlling block of stock is a "new offering." [57] Respondent has not attempted to make any distinction between these terms and appears to treat them as synonomous.[58] Accordingly, we find that Respondent's transactions in Park & Tilford stock were made as an underwriter and as part of a new offering to the public and that the exemptions of Section 3(a) (1) and the third clause of Section 4 (1) were not, therefore, applicable to such transactions. * * * we find it appropriate in the public interest and for the protection of investors to suspend Respondent from membership in the NASD for a period of 20 days.

An appropriate order will issue.

6. REGISTRATION STATEMENT AND PROSPECTUS

REGISTRATION OF SECURITIES AND SIGNING OF REGISTRATION STATEMENT

Sec. 6. (a) Any security may be registered with the Commission under the terms and conditions hereinafter provided, by filing a registration statement in triplicate, at least one of which shall be signed by each issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors or persons performing similar functions (or, if there is no board of directors or persons performing similar functions, by the majority of the persons or board having the power of management of the issuer), and in case the issuer is a foreign or Territorial person by its duly authorized representative in the United States; except that when such

[57] See H.R.Rep.No.85, 73d Cong., 1st Sess., p. 14 which in discussing the scope of a "new offering . . . by an issuer or underwriter" (the exception to the exemption provided in Section 3(a) (1) states:

"Also the exemption does not apply to any *redistribution* of outstanding issues which would otherwise come within the act." (Italics ours.)

[58] Respondent's brief, pp. 24-25 states:

"The terms 'new offering' and 'distribution' are nowhere defined in the statute. However, they undoubtedly connote a pre-arranged program for the distribution of a substantial block of securities, so that it finally rests in the hands of the investing public."

registration statement relates to a security issued by a foreign government, or political subdivision thereof, it need be signed only by the underwriter of such security. Signatures of all such persons when written on the said registration statements shall be presumed to have been so written by authority of the person whose signature is so affixed and the burden of proof, in the event such authority shall be denied, shall be upon the party denying the same. The affixing of any signature without the authority of the purported signer shall constitute a violation of this title. A registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered.

(b) At the time of filing a registration statement the applicant shall pay to the Commission a fee of one one-hundredth of 1 per centum of the maximum aggregate price at which such securities are proposed to be offered, but in no case shall such fee be less than $25.

(c) The filing with the Commission of a registration statement, or of an amendment to a registration statement, shall be deemed to have taken place upon the receipt thereof, but the filing of a registration statement shall not be deemed to have taken place unless it is accompanied by a United States postal money order or a certified bank check or cash for the amount of the fee required under subsection (b).

(d) The information contained in or filed with any registration statement shall be made available to the public under such regulations as the Commission may prescribe, and copies thereof, photostatic or otherwise, shall be furnished to every applicant at such reasonable charge as the Commission may prescribe.

(e) No registration statement may be filed within the first forty days following the enactment of this Act.

INFORMATION REQUIRED IN REGISTRATION STATEMENT

Sec. 7. The registration statement, when relating to a security other than a security issued by a foreign government, or political subdivision thereof, shall contain the information, and be accompanied by the documents, specified in Schedule A, and when relating to a security issued by a foreign government, or political subdivision thereof, shall contain the information, and be accompanied by the documents, specified in Schedule B, except that the Commission may by rules or regulations provide that any such information or document need not be included in respect of any class of issuers or securities if it finds that the requirement of such information or document is inapplicable to such class and that disclosure fully adequate for the protection of investors is otherwise required to be included within the registration statement. If any accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, is named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with the registration statement, the written consent of such person shall be filed with the registration statement. If any such person is named as having prepared or certified a report or valuation (other than a public official document or statement) which is used in connection with the registration statement, but is not named as having prepared or certified such report or valuation for use in connection with the registration statement, the written consent of such person shall be filed with the registration statement unless the Commission dispenses with such filing as impracticable or as involving undue hardship on the person filing the registration statement. Any such registration statement shall contain such other information, and be accompanied by such other documents, as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors.

TAKING EFFECT OF REGISTRATION STATEMENTS AND AMENDMENTS THERETO

Sec. 8. (a) Except as hereinafter provided, the effective date of a registration statement shall be the twentieth day after the filing thereof or such earlier date as the Commission may determine, having due regard to the adequacy of the information respecting the issuer theretofore available to the public, to the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issuer and the rights of holders thereof can be understood, and to the public interest and the protection of investors. If any amendment to any such statment is filed prior to the effective date of such statement, the registration statement shall be deemed to have been filed when such amendment was filed; except that an amendment filed with the consent of the Commission, prior to the effective date of the registration statement, or filed pursuant to an order of the Commission, shall be treated as a part of the registration statement.

(b) If it appears to the Commission that a registration statement is on its face incomplete or inaccurate in any material respect, the Commission may, after notice by personal service or the sending of confirmed telegraphic notice not later than ten days after the filing of the registration statement, and opportunity for hearing (at a time fixed by the Commission) within ten days after such notice by personal service or the sending of such telegraphic notice, issue an order prior to the effective date of registration refusing to permit such statement to become effective until it has been amended in accordance with such order. When such statement has been amended in accordance with such order the Commission shall so declare and the registration shall become effective at the time provided in subsection (a) or upon the date of such declaration, whichever date is the later.

(c) An amendment filed after the effective date of the registration statement, if such amendment, upon its face, appears to the Commission not to be incomplete or inaccurate in any material respect, shall become effective on such date as the Commission may determine, having due regard to the public interest and the protection of investors.

(d) If it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission may, after notice by personal service or the sending of confirmed telegraphic notice, and after opportunity for hearing (at a time fixed by the Commission) within fifteen days after such notice by personal service or the sending of such telegraphic notice, issue a stop order suspending the effectiveness of the registration statement. When such statement has been amended in accordance with such stop order the Commission shall so declare and thereupon the stop order shall cease to be effective.

(e) The Commission is hereby empowered to make an examination in any case in order to determine whether a stop order should issue under subsection (d). In making such examination the Commission or any officer or officers designated by it shall have access to and may demand the production of any books and papers of, and may administer oaths and affirmations to and examine, the issuer, underwriter, or any other person, in respect of any matter relevant to the examination, and may, in its discretion, require the production of a balance sheet exhibiting the assets and liabilities of the issuer, or its income statement, or both, to be certified to by a public or certified accountant approved by the Commission. If the issuer or underwriter shall fail to cooperate, or shall obstruct or refuse to permit the making of an examination, such conduct shall be proper ground for the issuance of a stop order.

(f) Any notice required under this section shall be sent to or served on the issuer, or, in case of a foreign government or political subdivision thereof, to or on

the underwriter, or, in the case of a foreign or Territorial person, to or on its duly authorized representative in the United States named in the registration statement, properly directed in each case of telegraphic notice to the address given in such statement. Securities Act of 1933, 15 U.S.C.A. §§ 77 f, g, h.

INFORMATION REQUIRED IN PROSPECTUS

Sec. 10. (a) A prospectus—

(1) when relating to a security other than a security issued by a foreign government or political subdivision thereof, shall contain the same statements made in the registration statement, but it need not include the documents referred to in paragraphs (28) to (32), inclusive, of Schedule A;

(2) when relating to a security issued by a foreign government or political subdivision thereof shall contain the same statements made in the registration statement, but it need not include the documents referred to in paragraphs (13) and (14) of Schedule B.

(b) Notwithstanding the provisions of subsection (a)—

(1) When a prospectus is used more than thirteen months after the effective date of the registration statement, the information in the statements contained therein shall be as of a date not more than twelve months prior to such use, so far as such information is known to the user of such prospectus or can be furnished by such user without unreasonable effort or expense.

(2) there may be omitted from any prospectus any of the statements required under such subsection (a) which the Commission may by rules or regulations designate as not being necessary or appropriate in the public interest or for the protection of investors.

(3) any prospectus shall contain such other information as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors.

(4) in the exercise of its powers under paragraphs (2) and (3) of this subsection, the Commission shall have authority to classify prospectuses according to the nature and circumstances of their use, and, by rules and regulations and subject to such terms and conditions as it shall specify therein, to prescribe as to each class the form and contents which it may find appropriate to such use and consistent with the public interest and the protection of investors.

(c) The statements or information required to be included in a prospectus by or under authority of subsection (a) or (b), when written, shall be placed in a conspicuous part of the prospectus in type as large as that used generally in the body of the prospectus.

(d) In any case where a prospectus consists of a radio broadcast, copies thereof shall be filed with the Commission under such rules and regulations as it shall prescribe. The Commission may by rules and regulations require the filing with it of forms and prospectuses used in connection with the sale of securities registered under this title. Securities Act of 1933, 15 U.S.C.A. § 77j.

DEFINITIONS

Sec. 2. (4) The term "issuer" means every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term 'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof

shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term "issuer" means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering. Securities Act of 1933, 15 U.S.C.A. § 77b (4).

(A) The phrase "other legal entity" of Section 2(4) does not include a corporation. Landay v. United States, 108 F.2d 698, C.C.A.Mich.1939, cert. den. 309 U.S. 681, 60 S.Ct. 721, 84 L.Ed. 1024, April 1, 1940 (the indicted defendants had voted their shares of stock in a block thereby dominating B Co., which, as "issuer," had violated Section 17(a) (1) and (2). It was held that defendants, by their acts, had made the acts of B Co. their own, thus making them "issuers" and criminally liable for the violations).

(B) The principal objective of the Securities Act is to protect investors by requiring a full and accurate disclosure of the material facts regarding securities offered for sale in interstate commerce or by the use of the mails. In order to accomplish this, the Act provides that, before non-exempt securities may be offered or sold to the public through the mails or in interstate commerce, a registration statement must be filed with the Commission and must become effective. In general, government and municipal securities and the issues of banks, railroads, and cooperatives are exempt from the provisions of the Act.

In order to register securities the issuer must file a registration statement on the particular form prescribed by the Commission as appropriate to the type of security proposed to be offered. When a registration statement is filed it becomes a public document designed to set forth all the material facts known to the issuer and the underwriters with regard to the company and the securities to be sold. These include, among other things, statements with regard to the character, size and profitableness of the business, its capitalization, the purpose of the issue, options outstanding against securities of the issuer, remuneration of officers and directors, bonus and profit-sharing arrangements, underwriters' commissions, and pending or threatened legal proceedings. Certified financial statements must be included. In order that investors may have in convenient form the basic material contained in the registration statement, the Act also requires that they be furnished a prospectus containing at least the more important information in the registration statement. In addition to providing the public information on which to reach an informed judgment with regard to whether or not to purchase securities, the registration statement and prospectus serve as a record of the representations made at the time the securities were sold, and thereby simplify the problem of proof in any legal proceedings which may arise with regard to whether the registration statement or the prospectus contains untrue or misleading statements or omits material information.

Experts were drafted from specialized classes of issuers to assist in the preparation of forms and rules suitable to the specialized needs of their particular fields. It has been the Commission's established practice from the outset to submit every proposed registration form to those persons to whom it would apply and to seek their comments and criticisms. Through this system improvement has been made from time to time in the process for registering securities. It has been the constant aim of the Commission to devise additional ways of simplifying the mechanics of registration that could be made effective without foregoing the protection of the public and investors. It should be borne in mind, however, when it is asserted that some of the disclosures required appear to be needlessly searching, that the evaluation of a corporate security by the public is difficult under the most favorable circumstances and it is rendered unnecessarily hazardous if it must be done with-

out all the relevant facts. It is not a simple thing to draft a registration form to meet the needs of vast corporations which are not simple, which had intricate capital structures, scores of subsidiary companies and far-flung and varied business activities. Late in 1942 the Commission effected a comprehensive simplification of a number of registration and reporting requirements under several of the statutes, including a new general form for registration of commercial and industrial corporate securities. This form, S-1, permits the filing of the prospectus as a principal part of the registration statement, thus eliminating much duplication between the prospectus and the registration statement proper.

The examination of a registration statement by the Commission's staff does not involve and is not concerned with an appraisal of the merits of the security as an investment since the Commission is not authorized to and does not pass judgment upon the soundness of any security. Under the Act, speculative or apparently unsound issues can be registered and sold provided the whole truth is told. It follows that the Commission does not direct the flow of capital or try to do so, although, of course, the necessity of disclosing the truth concerning the security flotations may affect their reception. The basic policy is not to attempt to protect the investor by insulating him from risk but to make available to him the information with which to gauge the risk.

The Commission has no authority specifically to require an amendment to the registration statement. However, it is authorized by Section 8 of the Act to issue an order preventing or suspending the effectiveness of a registration statement if, after notice and opportunity for hearing, it finds that the statement is inaccurate or incomplete in any material respect. Ordinarily this procedure is unnecessary and the Commission does not resort to it except in those cases where there has been a definite or intentional effort to conceal or mislead.

In the interest of good administration, fair treatment of registrants, and minimum interference with business, a procedure not specifically spelled out in the Act was adopted early in its administration. Registrants are informally advised of any material misrepresentations or omissions as promptly as possible after the statements are filed, thus affording an opportunity for the filing of correcting amendments before the statements become effective. Through this "letter of deficiencies" the Commission is able to advise the registrant of the information that must be corrected or supplemented in order to meet the disclosure standards prescribed by Congress. Another informal procedure that has proved useful is the pre-filing conference in which representatives of registrants and underwriters discuss problems in connection with the proposed filing with the Commission's staff for the purpose of determining in advance what types or methods of disclosure would be necessary under the circumstances of the individual case. This informal method of handling cases has injected an element of flexibility into the registration procedure which has proved so satisfactory that it has not been necessary to issue a stop order since 1941.

The time required to examine and clear a registration statement depends largely on whether a simple or complex situation is involved. The original Section 8(a) of the Act required a twenty-day waiting period after filing before the registration statement could become effective. Moreover, any amendment filed prior to the effective date starts the twenty-day period running anew unless the Commission accelerates the amendment by dating its filing back to the original filing date of the registration statement. The principal objectives of the waiting period are to give the public an opportunity to absorb the information in the prospectus or registration statement and to get away from the hasty methods of distribution previously in vogue which practically compelled minor distributors and dealers to make commitments blindly.

The Commission has endeavored to adapt its procedures to the accustomed practices of business men and distributors of securities in so far as this is consistent

with the intent of Congress and the protection of investors. When the Commission found, therefore, after a study of the needs of the business, that a twenty-day waiting period after the filing of amendments would, in many cases, involve an unnecessary hardship, it adopted the policy, when amendments are not too important and complicated, of permitting registration to become effective on the twentieth day after the original filing date or as soon thereafter as possible.

On August 22, 1940, Section 8(a) was amended, with the support of the Commission, to give the Commission discretionary authority to accelerate the effective date under certain circumstances without regard to the original twenty-day period. In other words, the amended section provides that the effective date shall be the twentieth day after the filing of a registration statement or such earlier day as the Commission may determine but the Commission is required to give due regard to such matters as the adequacy of the information respecting the issuer which has previously been made public and the ease with which the rights of the holders of the securities to be issued can be understood. The Commission cooperates with registrants in expediting registration as much as possible consistent with the public interest and the protection of investors. Registrants who are able readily to meet the standards of the Act and the rules of the Commission obtain effective registration of their securities in substantially less than twenty days after filing.

Since Section 5 of the Act prohibits offers or sales to be made prior to the effectiveness of the registration statement, issuers and underwriters were, at first, reluctant to send out any information to potential investors during the waiting period for fear such circulation would be construed as an offer to sell securities. Early in its history, therefore, the Commission, in order to make information available to potential investors, published several opinions of its general counsel to the effect that distribution of information contained in the registration statement prior to the effective date of the registration statement would not constitute an illegal offer provided it were very clearly explained that the circulation was not intended as an offer of the security. This has resulted in the more or less common practice of underwriters and dealers circulating, prior to the effective date of the registration statement, the so-called "red herring" prospectus which derives its name from the practice of printing in red letters either diagonally across or along the margin of each page a clear statement that the document is not intended as an offer of the security and directing attention to the prohibitions in the Act against offers prior to effective registration. (Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934–1944, pp. 2–4.)

IN THE MATTER OF THOMAS BOND, INC.

5 S.E.C. 60, 1939.

This is a proceeding under Section 8(d) of the Securities Act of 1933, 15 U.S.C.A. § 77h(d), to determine whether a stop order should issue suspending the effectiveness of a registration statement filed September 28, 1938, on Form A-1 by Thomas Bond, Inc., a Delaware corporation. * * *

In our opinion the principal deficiency in this registration statement relates to the balance sheet submitted in answer to Item 54.

The registrant's authorized capital stock consists of 50,000 shares of Class A Common, par value $5, and 150,000 shares of Class B common, par value 50 cents. Registration is sought for the Class A shares and 50,000 of the Class B, which are to be sold in units of one share each at $5 per unit. With the proceeds the registrant intends to engage in the manufacture and sale of cosmetics and allied lines, es-

pecially a product developed by its president, Thomas Bond, and described as an easily self-applied face dressing unlike any other preparation on the market.

All of the authorized Class B stock, 150,000 shares with a par value of $75,000, was issued to Bond in exchange for a formula for the cosmetic and in consideration of disbursements and advances made on behalf of the issuer amounting to $2,792.07. As part of the same transaction Bond donated back to the issuer 50,000 shares. The formula thus acquired is carried in the registrant's balance sheet, as of August 31, 1938, at $72,207.93, which sum represents the difference between the par value of the shares issued to Bond and the advances made by him to the corporation.

We have frequently held that to permit the amount at which property is carried on the balance sheet to include the par value of shares issued therefor and concurrently donated back to the issuer is improper and misleading. In the matter of Unity Gold Corporation, 1 S.E.C. 25, 32, 1934; In the matter of Yumuri Jute Mills Company, 2 S.E.C. 81, 85–86, 1927; In the matter of Bering Straits Tin Mines, Inc., 2 S.E.C. 486, 496, 1937; In the matter of Virginia City Gold Mining Company, 2 S.E.C. 855, 858, 1937.

In addition to setting up the formula at the full amount of the par value of the shares issued for it, without deducting the shares donated to the issuer, the registrant credited "surplus" with $25,000 representing the shares donated. This "surplus" is as fictitious as the excess amount at which the formula was carried on the balance sheet.

The balance sheet item for the formula should have been further reduced by an amount equal to the par value of shares issued for promotional services. Out of the 100,000 shares of Class B stock remaining in Bond's possession after the donation previously referred to, Bond issued 25,900 shares to Norman W. Cook, secretary-treasurer of the issuer, and 1,000 shares to O. William Goes, vice-president. Although Bond is the only person named in the registration statement as a promoter, it is disclosed elsewhere in the registration statement that these shares were issued "in consideration of valuable services rendered to him and to the Company during the organization period." Bond, being at the time in complete control of the company, was merely a conduit through which these shares were in effect transferred by the company to the other promoters. Proper accounting practice, we have previously held, requires that shares issued for promotional services be listed separately from expenditures representing the consideration paid for physical property. In the matter of Unity Gold Corporation, supra; In the matter of Richard Ramore Gold Mines, Ltd., 2 S.E.C. 377, 390, 1937. We know of no sound reason for any different treatment in the case of an intangible asset such as the registrant's formula.

Finally, even if the amount at which the formula was carried on the balance sheet had been reduced to eliminate the shares donated back and those issued for the promotional services, still the remaining figure is misleading in the absence of a statement that it was arbitrarily fixed by the registrant and the vendor, who was the principal pro-

moter, without arms-length bargaining and without any reference to the cost of the formula to the vendor. A dollar-and-cents figure set opposite an item of property implies that it was reached on some rational or precise basis; the fact that it was arbitrarily reached should be disclosed.

It follows that the balance sheet submitted in response to Item 54 is inaccurate and materially misleading.

There are several other matters remaining to be considered. Several of them are of such a nature that, in the absence of the important deficiency already noted, it would be at least questionable whether it would not be best to permit amendments to be made rather than resort to a stop order.

Facing Page. The date of the proposed public offering, among other information, is required to be disclosed on the facing page. Since this was not done, the facing page is deficient.

Item 3. This item requires a brief statement of the business done and intended to be done by the issuer. The registrant's answer mentions the name under which it proposes to market its products, but fails to disclose that the name selected has, for some time, been the registered trade-mark of another concern. This was one of the more important omissions.

Item 11. This item calls for the names and addresses of directors and the chief executive, financial and accounting officers of the issuer. The registrant's answer indicates that Bond, Cook and Goes are president, secretary-treasurer, and vice-president, respectively, of the issuer, but fails to disclose the fact that they are also the directors of the corporation. The answer to the item is therefore materially deficient.

Item 13. This item calls for the names and addresses of the promoters of the corporation. The registrant named only Thomas T. Bond. The evidence shows that both Norman W. Cook and O. William Goes assisted Bond in getting the enterprise under way. The three consulted together frequently. Cook contributed financial aid, and Goes, who was in the advertising business, frequently advised Bond concerning marketing problems. Not only were these two men recompensed by payments in stock out of the 100,000 shares received by Bond, but both became members of the registrant's original board of directors. They were not engaged by Bond to do any particular task, but joined with him in planning and financing the enterprise. We find that both Cook and Goes were promoters and that the answer to Item 13 omitted to state material facts.

Item 15. This item requires the name and address of the independent certified or public accountant, if any, preparing and certifying audits or examinations of the issuer's accounts, together with the scope, frequency, and regularity thereof. The registrant's answer consisted merely of the name and address of the accountant who prepared the financial statements submitted as a part of the registration statement. There is evidence in the record that the registrant had made tentative arrangements for periodic audits although none had been made up to the time of the filing of the registration statement. The answer, in

our opinion, is deficient for failure to disclose the nature of these arrangements.

Items 19 and 20. Items 19 and 20 call for certain information concerning the stock authorized, outstanding, and to be issued under the registration statement. The registrant's answer to Item 19 states that 150,000 shares of Class B stock are outstanding, without indicating that 50,000 shares of this amount had been donated to the corporation. There was no indication in these items that 50,000 of the 150,000 shares were treasury stock rather than outstanding in the hands of the public. Both Item 19 and Item 20 require disclosure of the dividend rate, if any, for each class of stock. The registrant's answers stating that the dividend rate of the Class A stock is 35 cents are inadequate. The fact should also have been disclosed that dividends on the Class A stock are cumulative when earned, and only to the extent earned. It follows that Items 19 and 20 are materially deficient.

Item 27. This item calls for a detailed statement of the uses to which the proceeds of the issue are intended to be put. The registrant answered with estimates in certain fairly broad categories, such as: "Estimated cost of raw materials, packaging, labels, etc., sufficient for one year's supply * * * $49,000;" "Estimated cost of machinery and equipment (Factory $3,000.00; Office $2,000.00) * * * $5,000;" "Estimated expenditure for advertising through newspaper and radio channels, counter and window displays * * * $54,000." Counsel for the Commission challenged the answer on the grounds that the estimates were inaccurate and not sufficiently detailed. None of the estimates was proved to be inaccurate, and we agree with the trial examiner's finding that they are as detailed as can be expected from a corporation in a promotional stage. We find no deficiency in this item.

Item 33. Item 33 calls for a statement of the price per unit at which the securities are to be sold to the underwriter. The answer states, among other things, that the underwriter, Franklin Flick & Company, Incorporated, has agreed to "take down" the entire offering. This expression, as we have previously held, creates the impression that the underwriter has entered into a binding commitment to purchase the registrant's securities. Since the underwriter of the present offering is required by his contract merely to use his best efforts to sell the issuer's securities, the statement above referred to is materially misleading.

Item 34. This item calls for the price per unit at which the security is proposed to be offered to the public. The registrant has stated that its securities will be offered at $5 a unit of one share of Class A and one share of Class B, but that if the shares are listed on an exchange then the price shall be determined for each day by the closing price on the exchange for the previous day. Counsel for the Commission points out that in the underwriting agreement it is provided that the underwriter reserves the right to trade in units for its own account. In view of this provision it was claimed that the answer to Item 34 was deficient for failure to state whether or not the underwriter intends to stabilize the market. We have previously held that where securities

are offered "at the market" and where there has been activity influencing the market or where it is intended to influence the market in the future, such facts must be set forth. Since the underwriter reserved the right to trade in these securities for its own account, we find that it was incumbent on the registrant to disclose that fact and the intention of the underwriter as to whether this right was to be used to stabilize the securities. We therefore find that the registrant omitted to state material facts necessary to be stated.

Item 36. This item requires a statement of the commissions to be paid to each underwriter. The answer, like the answer to Item 33 discussed above, implies that there is a firm obligation on the part of the underwriter to take the entire issue. The item is materially deficient in this respect.

Furthermore, there was not disclosed in answer to the item a service contract between the issuer and Franklin Flick & Company, the underwriter, pursuant to which the underwriter has received $1,250 in recompense for services in connection with the registration of the issue. We find that this agreement was so closely connected with the "sale" of the securities that it should have been disclosed in response to the item.

Finally the underwriting contract provided for an alternative measure of compensation to the underwriter in the event the registrant should fail to perform its part of the agreement. We find that the omission to set this forth was material.

Item 37. This item requires an itemized statement of expenses, other than commissions, incurred or to be incurred in connection with the sale of the securities to be offered. The statement of expenses furnished was not itemized. Furthermore, the expenses to be incurred for printing stock certificates, for stamp tax, etc., enumerated by the registrant under Item 27 were not included. We find the answer to the item materially deficient.

Item 39. This item, among other things, calls for the names and addresses of promoters to whom any amounts have been paid within two years preceding the filing of the registration statement, or to whom any amount is intended to be paid, and the consideration therefor. Although the registrant's answer supplies information concerning the issuance of stock to Bond, Cook and Goes, no mention is made of the fact that Bond will receive $6,000; Cook, $4,000; and Goes, $2,000 for their services as president, secretary-treasurer, and vice-president, respectively, during the issuer's current fiscal year. This information, it is true, is furnished elsewhere in the registration statement, but, as we have said, "it is Item 39 to which investors will naturally turn for a complete statement of the promoters' total compensation." In the matter of West Park Apartments Corporation, 13 S.E.C. 900, 1938, Securities Act Release No. 1811. These salaries should have been disclosed, and the answer to Item 39 is materially deficient for this reason. Cf. In the matter of Doris Ruby Mining Company, 4 S.E.C. 427, 1939, Securities Act Release No. 1884.

Items 40–44. These items require information as to the use to be made of the proceeds of the issue in making purchases not in the or-

dinary course of business. The registrant has answered that it does not intend to make any such purchases. It is evident that a corporation in the promotional stage must make initial expenditures which are not "in the ordinary course of business." In this case the answer to Item 27 shows an intention to do so. Therefore the answers to these items omit material information. In view of the fact that it would be obvious to investors that the registrant must make purchases not in the ordinary course of business, we would not, in the absence of other deficiencies, base a stop order on these omissions alone.

Item 45. This item calls for the details of any sales within the past two years of property to the corporation by directors, officers, underwriters or principal stockholders. The registrant has set forth briefly the sale of the formula and trade name by Bond to the corporation. Counsel for the Commission asserts that the answer should be amplified by setting forth the cost of the formula and the trade name to Bond. The purpose of this item is obviously to disclose profits made by the named persons from sales to the corporation. If a promoter had purchased property sold to a corporation, we believe the price he paid, and the profit he received, should be set forth. In the matter of La Luz Mining Corporation, 1 S.E.C. 217, 1935. Similarly, where the promoter and principal stockholder's interest in the property is a result of discovery or invention, the cost of development is the only measure of his financial interest. Although the property may be worth the amount paid therefor by the registrant, investors are entitled to full information as to the extent of the promoters' interest and profit.

Item 46. This item calls for the dates of, parties to, and general effect of, all material contracts not made in the ordinary course of the issuer's business. We find that the registrant's summary of its agreement with Franklin Flick & Company is incomplete. It does not disclose a provision whereby the issuer, in the event the agreement is not carried out by it, becomes liable to the underwriter to the extent of $1,000 per month and 10% of the public offering price of any unsold securities. This was a material omission.

The answer is further deficient in failing to summarize the contract with the underwriter by which the latter agreed to have the securities registered.

Item 52. Under this item the registrant is required to submit, among other things, a complete list of the parents of the issuer. The answer states that the issuer has no parents, and further that it is controlled jointly by Bond, who owns 73,100 shares or 48.73%, and Cook, who owns 25,900 shares or 17.2% of the present outstanding Class B (voting) stock. These percentages are incorrect, having been based upon the supposition that 150,000 shares of Class B stock were outstanding. As previously noted under Items 19 and 20, the issuer has but 100,000 shares of Class B outstanding in the hands of the public. On this basis, Bond would appear to own 73.1% of the outstanding stock and thus control the issuer. The term "parent" is defined by our rules as a person that directly, or indirectly, through one or more intermediaries, controls another. Item 52 is therefore deficient in fail-

ing to name Bond as a parent. In the matter of Austin Silver Mining Company, 3 S.E.C. [601] 1938, Securities Act Release No. 1774.

Item 53. This item calls for a description of the voting rights, preferences, conversion, exchange rights, rights to dividends, profits, etc., for each class of capital stock previously authorized and outstanding. The registrant in its answer summarized pertinent provisions of its charter. Counsel for the Commission claims that the answer is deficient because it fails to state that there are no exchange or conversion rights. We believe that the absence of a description of such rights implies a negation that such rights exist and that the item is not deficient in this respect.

Item 54. The deficiencies in this item have been discussed above.

* * *

Accountant's Certificate. Rule 651 of the General Rules and Regulations under the Securities Act of 1933 specified the minimum contents for accountants' certificates required to be filed with financial statements. Among other things, this rule provides that the certificate of the accountant shall state clearly the opinion of the accountant as to "the accounting principles and procedures followed by the person or persons whose statements are furnished." The registrant included in its registration statement a certificate by Herman A. Mueller certifying that the financial statements were in accordance with accepted principles of accounting, but omitting entirely any reference to the principles and procedures followed by the registrant. We find that the certificate failed to comply with Rule 651 in this respect.

Attorney's Consent to Use of Statement in Registration Statement. An opinion of an attorney for the registrant on the legality of the formation of the corporation and on the issue of its stock was included in the registration statement as Exhibit F. The opinion concluded with a consent by the attorney to the use of the opinion in connection with the registration statement. However, the opinion and consent filed with the Commission is not signed by counsel although there is a certificate by the secretary of the corporation that it is a true copy. Section 11 of the Securities Act imposes certain liabilities on a person "whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement." Section 7 of the Act requires that "the written consent of such person shall be filed with the registration statement." We interpret this provision, in view of the serious consequences which might result from the improper use of the opinion of an expert, to require that an original (or duplicate original) of the consent be filed. We find that the filing of an unsigned duplicate does not comply with Section 7.

Prospectus. The statement is made in the prospectus that the cosmetic proposed to be manufactured by the registrant "conquers lines, blackheads, oily skins and coarse pores." Government experts, however, testified that the product had no medicinal or curative properties and would not accomplish the results claimed. In fact, officers of the registrant corporation admitted at the hearing that it merely

concealed these conditions. It follows that the statement above quoted is untrue.

The registrant has included in its prospectus a statement of the "investment and speculative possibilities" of its securities. Under this heading the registrant has first stated that "The Corporation's earnings possibilities can only be correctly estimated at such time as production is in full operation on a regular Schedule." After this warning the prospectus goes on to estimate (on the basis of the total number of drug stores and a sale of 40 jars a store by half of them) annual sales of over 1,000,000 jars a year, and further states, "The profit margin, after allowing the highest expense burden possible against a sales figure well under one million jars, is still slightly in excess of 25%, a figure which should increase as time goes on and the merits of the product become more widely known and a new business and repeat orders swell the sales volume." It is our opinion that these statements lend an appearance of predictability of future profits which is improper for a corporation which has yet to start business. Although stated as an estimate of future profits, the use of definite figures is misleading.

The prospectus is also deficient in so far as it reflects the omissions and misstatements previously discussed.

To sum up: We find that the facing page, Items 3, 11, 13, 15, 19, 20, 33, 34, 36, 37, 39, 40, 41, 42, 43, 44, 45, 46, 52, and 54, the accountant's certificate, the attorney's consent and the prospectus are, for reasons stated, materially deficient. We find no material deficiencies in Items 14, 27, and 53 and in Schedules 2, 3, and 5 to the balance sheet.

Although the proposed amendments submitted after the record was closed would seem to cure many of the deficiencies charged in the original notice, they appear on their face to be incomplete and inaccurate in certain material respects. The Commission is therefore precluded by Section 8(c) of the Act from exercising its discretion to permit the amendments to become effective. In the matter of Unity Gold Corporation, 3 S.E.C. [618], 1938.

A stop order will issue in accordance with these findings.

NOTE

The provisions of the Securities Act authorize the Commission to refuse to permit a registration statement to become effective if it appears on its face to be incomplete or inaccurate in any material respect, and empower the Commission to issue a stop order suspending the effectiveness of any registration statement which at any time is found to include any untrue statement of a material fact or to omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading. These provisions of the Act have been construed by the courts in several important cases. In Jones v. S.E.C., 298 U.S. 1, 56 S.Ct. 654 (1936), a majority of the Supreme Court (Justices Cardozo, Brandeis and Stone dissenting) held that the commencement of stop order proceedings by the Commission prevented Jones' registration statement from ever becoming effective and that since none of the securities sought to be registered had been offered or sold there was no public interest which could be prejudiced by its withdrawal in accordance with Jones' request. On this basis the Court held that the Commission had erred in denying withdrawal of the statement. This decision has been considered as largely

limited to the procedure which the Supreme Court deemed proper for the Commission to employ in connection with the suspension of the effectiveness of registration statements. In a later case in 1939, Oklahoma-Texas Trust v. S.E.C., 100 F.2d 888, the Circuit Court of Appeals for the 10th Circuit unanimously affirmed an order of the Commission suspending the registration of securities because of fraudulent misstatements contained in the registration statement. There it appeared that all of the securities registered had been sold prior to the commencement of the stop order proceedings and the Trust contended that under the authority of the Jones case the Commission had lost its power to issue a stop order. The court distinguished the Jones case, however, on the ground that here the public interest would be prejudiced by permitting the registrant to withdraw its registration statement. Immediate and subsequent purchasers of the securities were entitled to be apprised of the fact that the registration statement, a matter of public record, upon which they had relied, was false and misleading, and to have the benefit of the civil liability provisions which gave them various remedies for the losses which they sustained on the securities. In other cases the courts have held that a stop order suspending the effectiveness of a registration statement is not reviewable by the courts after it has been lifted upon the filing of amendments in accordance with the stop order (Austin Silver Mining Co. v S.E.C., 1 S.E.C. Jud.Dec. 732, App.D.C., 1939), and that an order denying a motion for permission to withdraw a registration statement without prejudice to renewal at the conclusion of the hearing then pending in connection with the stop order proceedings is merely interlocutory and not reviewable under the Act (Resources Corporation v. S.E.C., 97 F.2d 788, C.C.A.7, 1938). (Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934–1944, p. 9.)

7. LIABILITIES ARISING FROM VIOLATIONS OF THE ACT

Thousands of complaints are received from the public each year in addition to matters brought to the attention of the Commission by the several state securities officials, Better Business Bureaus and other federal and state authorities. All of these receive careful attention and where it appears that the statutes have been violated, an investigation is instituted. The bulk of the investigative work is performed by the ten regional offices which are strategically located in financial centers throughout the country. Where violations have occurred legal action is instituted by the Commission. Such action may be either civil or criminal. The civil actions consist primarily of actions for injunctions against the continuance of the violations. Such actions are instituted in the appropriate United States District Court and permanent injunctions are obtained in the great majority of cases. These are usually preceded by preliminary injunctions, and in instances where serious and immediate violations are threatened, by a temporary restraining order. * * *

The most stringent remedy possessed by the Commission is its power to refer cases for criminal prosecution to the Department of Justice. When such action is warranted after a thorough investigation, a detailed report is made and submitted to the Attorney General. Members of the Commission's staff work in conjunction with the Department of Justice in preparing the case and presenting it to the Grand Jury and also frequently participate in the trial. (Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934-1944, p. 13.)

(a) Civil

CIVIL LIABILITIES ON ACCOUNT OF FALSE REGISTRATION STATEMENT

Sec. 11. (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1), and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an

expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

(d) If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

(e) The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, that if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) for damages in excess of the total price at which the securities underwritten by him

and distributed to the public were offered to the public. In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) All or any one or more of the persons specified in subsection (a) shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public. Securities Act of 1933, 15 U.S.C.A. § 77k.

CIVIL LIABILITIES ARISING IN CONNECTION WITH PROSPECTUSES AND COMMUNICATIONS

Section 12, supra, p. 732.

LIMITATION OF ACTIONS

Sec. 13. No action shall be maintained to enforce any liability created under section 11 or section 12 (2) unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 12 (1), unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section 11 or section 12 (1) more than three years after the security was bona fide offered to the public, or under section 12 (2) more than three years after the sale. Securities Act of 1933, 15 U.S.C.A. § 77m.

CONTRARY STIPULATIONS VOID

Sec. 14. Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void. Securities Act of 1933, 15 U.S.C.A. § 77n.

LIABILITY OF CONTROLLING PERSONS

Sec. 15. Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist. Securities Act of 1933, 15 U.S.C.A. § 77*o*.

ADDITIONAL REMEDIES

Sec. 16. The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity. Securities Act of 1933, 15 U.S.C.A. § 77p.

UNLAWFUL REPRESENTATIONS

Sec. 23. Neither the fact that the registration statement for a security has been filed or is in effect nor the fact that a stop order is not in effect with respect thereto shall be deemed a finding by the Commission that the registration statement is true and accurate on its face or that it does not contain an untrue statement of fact or omit to state a material fact, or be held to mean that the Commission has in any way passed upon the merits of, or given approval to, such security. It shall be unlawful to make, or cause to be made, to any prospective purchaser any representation contrary to the foregoing provisions of this section. Securities Act of 1933, 15 U.S.C.A. § 77w.

SHONTS et al. v. HIRLIMAN et al.

District Court of the United States, S. D. California, 1939. 28 F.Supp. 478.

Three actions which were consolidated for trial, by Sydney L. Shonts and others against George A. Hirliman and others by W. W. Caldwell against the same defendants, and by Lester E. Wogahn against the same defendants, for damages, under the provisions of the Securities Act of 1933, § 11, 15 U.S.C.A. § 77k, establishing civil liability against persons for falsity in a registration statement. On defendants' motions to dismiss the complaints.

Motions granted.

The plaintiffs, who were purchasers of stock in Condor Pictures, Incorporated, brought three actions against certain officers of the corporation and Webster, Atz & Company, the auditors, to recover damages, the price paid for the stock, under the provisions of the Securities Act of 1933, section 11, 15 U.S.C.A. § 77k, establishing civil liability against certain persons for falsity in the registration statement. The cases were consolidated for trial. The falsity relied on related to misrepresentations and omissions concerning a lease by the Condor Pictures, Incorporated, and Western Service Studios, and more particularly, the failure to set forth in the amendments to the registration statement, dated January 23, 1937, and February 1, 1937, that Condor Pictures, Incorporated, was obligated under the lease to use the studio a minimum of one hundred days a year at a total rental of thirty-five thousand dollars. The form in which the alleged false statements appeared on the respective dates in the second and third amendments was:

The second amendment to Registration Statement, paragraph No. 3 read:

"The issuer is fully equipped to carry out its present program and business. It owns no substantial physical properties or studios but carries on its production program at the present by rental of the use of studio and equipment at RKO Pathe Studio, Culver City, California. This policy will be continued by the issuer until such time as it becomes advantageous to purchase or build its own studio. At the present time this does not appear advisable as there are fully equipped operating studios available for rental one of which the issuer is now leasing and which is more than ample for the present requirements. There are sufficient space, equipment and facilities to meet Issuer's requirements

even should the present production program be doubled. The issuer's leasing arrangement with the studio provides the issuer with all necessary equipment for the production volume above stated in addition to all necessary offices for production staff.

"It is not necessary for the issuer to make any substantial investment in equipment because the studio lease provides the issuer with the essentials.

"The affiliate of the issuer, The Van Beuren Corporation, does not own any physical property or equipment of material account, neither does it require the ownership of such property or equipment for the present or proposed program. The properties and studio or location and equipment used by said Company are likewise leased. The volume that may be produced with properties and equipment so leased is more than double the present program."

The third amendment read:

"The issuer is fully equipped to carry out its present program and business. It owns no substantial physical properties or studios but carries on its production program at the present by rental of the use of studio and equipment at the Western Service Studios, Hollywood, California. This policy will be continued by the issuer until such time as it becomes advantageous to purchase or build its own studio. At the present time this does not appear advisable as there are fully equipped operating studios available for rental one of which the issuer is now leasing and using and which is more than ample for the present requirements. There are sufficient space, equipment and facilities to meet issuer's requirements even should the present production program be doubled. The issuer's leasing arrangement with the studio provides the issuer with all necessary equipment for the production volume above stated in addition to all necessary offices for production staff.

"The Western Service Studios are rented to the registrant by Grand National Films, Inc., the present lessee, for a period of approximately one (1) year from the date of this registration statement with options to renew granted solely to the registrant for a further nine (9) year period terminable only by the registrant at the end of any year during the first four (4) years of the 9-year period but not terminable during the succeeding five (5) year period if the registrant exercises its option to renew at the commencement of said 5-year period. The rental basis is at the rate of $350 per shooting day with no payments for any days on which there is no shooting. It is not necessary for the issuer to make any substantial investment in equipment because the studio lease provides the issuer with the essentials.

"The affiliate of the issuer, The Van Beuren Corporation, does not own any physical property or equipment of material account, neither does it require the ownership of such property or equipment for the present or proposed program. The properties and studio or location and equipment used by said Corporation are likewise leased. The volume that may be produced with properties and equipment so leased is more than double the present program."

Paragraph No. 46 read:

"The registrant has entered into a rental agreement with Grand National Films, Inc., the present lessee of the Western Service Studios

in Hollywood, California, whereby space, facilities and equipment to meet the requirements of the registrant's production program, even should it be doubled, together with all necessary offices for production staff are rented to the registrant. The studio is a fully equipped operating studio and the amount of space varies and is made available according to the stage and settings required.

"The Western Service Studios are rented to the registrant by Grand National Flims, Inc. for a period of approximately 1 year from the date of this registration statement with options to renew granted solely to the registrant for a further 9-year period terminable only by the registrant at the end of any year during the first 4 years of the 9-year period but not terminable during the succeeding 5-year period. The rental basis is at the rate of $350 per shooting day with no payments for any days on which there is no shooting. A copy of this agreement is to be filed as a post effective amendment to the registration statement."

The evidence showed that a formal lease was not entered into until March 9, 1937. However, a telegram signed by the President of Western Service Studios, dated January 31, 1937, committed the company to a rental arrangement to be followed by a formal leasing. This telegram, however, did not refer to a minimum guarantee. On May 11, 1937, the Securities Exchange Commission issued a stop order by reason of the alleged misrepresentations in the registration statement. The auditors, in their certificate dated January 19, 1937, did not set up the obligation to pay a minimum rental of $35,000 as a contingent liability. The defendants stipulated, without conceding the materiality of the matter, that the stock had no market value. The plaintiffs did not offer any evidence as to the actual value of the stock at the time the actions were instituted. At the conclusion of the plaintiffs' case, the defendants moved to dismiss the complaints upon the ground that no damage had been shown and that the actions were barred by Section 13 of the Securities Act of 1933, 15 U.S.C.A. § 77m. * * *

YANKWICH, DISTRICT JUDGE (after stating facts as above). * * * This Act, however, creates a civil liability of a specific character. It provides that if any part of the registration statement contains an untrue statement of material facts or omits to state material facts, the person who acquires the security, wihout knowledge of the untruth or omission, may sue either at law or in equity, the person who signed the registration statement, the officers or directors of the corporation which applied for the registration, and the accountants or others who certified to the registration statement or prepared it. 15 U.S.C.A. § 77k.

The measure of damages is not the one which usually obtains in fraud,—the difference between the value of the thing bought and what it would have been if it had been as represented. * * *

The Act, in section 11, subdivision (e), provides that the recovery shall be of such damages as shall represent the difference between the amount paid for the security and "(1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at

which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought." 15 U.S.C.A. § 77k (e).

It is evident that the Congress intended to make the action, notwithstanding its origin in fraud, purely compensatory. And so, it provided for the recovery of the price paid. It anticipated three possible contingencies: (1) Where there has been no sale of the stock; (2) where there has been a sale of the stock before the action was brought or (3) a sale after the action was brought.

Where there has been no sale of the stock, the recovery is for the difference between the value of the stock when purchased, and its value as of the time suit is brought. Where there has been a sale, the recovery is for the difference between the price received by the seller and the price he paid.

Before disposing of this question and the question of limitation, I comment briefly on the evidence in the record as it relates to the elements of the action created by the statute.

I am satisfied that the omission from the statement of the minimum requirements in the leases, which obligated Condor Pictures, Inc., to shoot at least 100 days a year, is material. It is not of any great signifiance that the lease was not actually entered into until later. For that reason, I am of the view that there is no falsity in the statement that they had certain rental arrangements with a particular company. I think the oral negotiations and the telegram of January 1, 1937, showed a commitment which the parties themselves considered binding, and which was to be later embodied in a more formal instrument. The effect of these conclusions is this: No misstatement or omission appears in the registration statement until after the last certificate of Webster, Atz & Co., dated January 19, 1937. Prior to January 31, 1937, there were merely discussions of rental, and no definite undertaking by either side or guarantee of a minimum, which was binding on the company. The failure of the certificate of Webster, Atz & Co. to set up the rental undertaking and the minimum guarantee of $35,000 as a contingent liability, is not the omission of anything which existed then. The rental arrangement was not called to their attention. There was no entry on the books at their disposal, from which, by further inquiry, they might have discovered that there was such an undertaking. Absent these, they cannot be charged with a misrepresentation which was made later—long after their certification.

In sum, we cannot, as to Webster, Atz & Co., take the subsequent omissions and retroject them to the date of January 19, 1937, so as to "tie" them to a certificate, which they made on the basis of facts as they then existed and which showed no rental arrangement of any kind.

We return to the element of damages. It is stipulated that, at the time the actions were begun, the stock had no "market value." *But it is not conceded* that it had *no intrinsic value.* In the view I take, this value is of utmost importance. The object of the statute is not to penalize promoters or auditors for the full value of the stock, merely

because the stock—which may be that of a new corporation—might not have a "market value." The object of the Congress was to compensate a person for the depreciation in the value— *the actual value* of his security.

Mark you, the object of this section is compensatory. No penalties are intended. The object is not to recover the *full value* of the stock, *under all circumstances.* The plaintiffs are not required, as a condition precedent to recovery, to surrender for cancellation to the defendants or to the court, the stock, or even to tender it back. They retain it. If, as counsel claim, they may retain the stock and then recover its full value by showing that there is no market for it at a particular time, then we have this situation: A person might recover the full value of the stock, retain his position as a stockholder in the corporation, exercise his full rights as such, and then, at some future time, when the stock had acquired a "market value," reap the full benefit of his investment, after he has already been repaid it. This would be a penalty, inconsistent with the compensatory nature of the Act.

The finding of insolvency in the reorganization proceedings is not proof that the stock was valueless. * * *

Judge Jenney did not order liquidation. Had he ordered liquidation, it might be argued that we are in bankruptcy and ought to consider it as though an adjudication had been made upon an involuntary petition, and that it refers back to the date of the petition. But, he did not do so. He continued the efforts at reorganization. His only object in making the finding was to say to the reorganizers: "You may proceed to formulate a plan, and if that plan is approved by me, it will be confirmed when you secure the assent of two-thirds of the creditors. You do not need the assent of a majority of the stockholders."

We cannot retroject into the past this finding, which says that insolvency exists *"at this time,"* so as (in the language of the street) "to pin" insolvency on the corporation as of November 29, 1937.

The documentary evidence offered to show insolvency is insufficient. We have an auditor's summary of the books of the company, which shows an operating loss, during a certain period of time. But an operating loss is not the equivalent of insolvency, either in the sense of inability to meet debts—which, of course, would not help us here —or in the sense that the assets, at a fair valuation, are less than the liabilities.

I am of the view, therefore, that the evidence does not show insolvency, so as to warrant the court in concluding that, on the date when these suits were instituted, between March and October, 1937, the stock was of no value, so as to entitle the plaintiffs to recover without proof of value. * * *

It follows that the motions to dismiss should be granted as to all the defendants. It is so ordered. The causes are also dismissed as to defendants named but not served.[59]

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[59] See an excellent note in 1940, 38 Mich.L.Rev. 1103.

See, also, Note, Federal Securities Act: Civil Liabilities for Issuance of False Registration Statement: Methods of Uniting Actions and Assigning Claims, 1941, 26 Corn.L.Q. 488.

NOTE

Although it is not necessary for plaintiff in his complaint to allege that the suit is brought within the one year period allowed by the statute of limitations, he must allege when he discovered the falsity relied upon as the basis of the suit. Hall & Co. v. Johnson, 103 N.Y.L.J. 589, N.Y.Sup.Ct., Special Term, Feb. 6, 1940.

DECKERT et al. v. INDEPENDENCE SHARES CORPORATION et al.

DECKERT et al. v. PENNSYLVANIA CO. FOR INSURANCES ON LIVES AND GRANTING ANNUITIES.

Supreme Court of the United States, 1940. 311 U.S. 282, 61 S.Ct. 229, 85 L.Ed. 189.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

Suit by Robert J. Deckert and others against the Independence Shares Corporation, the Pennsylvania Company for Insurances on Lives and Granting Annuities, and others, for the appointment of a receiver and the liquidation and dissolution of the Independence Shares Corporation and for certain injunctive relief. From an order denying motions to dismiss the bill of complaint, 27 F.Supp. 763, the Independence Shares Corporation and others appealed, and from an order enjoining the Pennsylvania Company for Insurance on Lives and Granting Annuities from paying over a certain sum of money to the Independence Shares Corporation, or otherwise disposing of it during pendency of the suit, the Pennsylvania Company for Insurances on Lives and Granting Annuities appealed, and to review a decision of the Circuit Court of Appeals, 108 F.2d 51, which reversed the orders and remanded the cause with directions, the plaintiffs bring certiorari.

Reversed and remanded.

MR. JUSTICE MURPHY delivered the opinion of the Court.

Two important questions are presented by these petitions. The first is whether the Securities Act of 1933, 48 Stat. 74, 15 U.S.C.A. § 77a et seq., authorizes purchasers of securities to maintain a suit in equity to rescind a fraudulent sale and secure restitution of the consideration paid, and to enforce the right to restitution against a third party where the vendor is insolvent and the third party has assets in its possession belonging to the vendor. The second question is whether such purchasers must show that the amount in controversy exceeds $3,000 exclusive of interest and costs as required by Section 24 of the Judicial Code, as amended, 28 U.S.C. § 41, 28 U.S.C.A. § 41.

Petitioners, with one exception residents of Pennsylvania, are owners and holders of Capital Savings Plan Contract Certificates purchased from Capital Savings Plan, Inc., since merged with and now Independence Shares Corporation, a Pennsylvania corporation. These certificates required the holders to make certain installment payments to The Pennsylvania Company for Insurances on Lives and Granting Annuities, also a Pennsylvania corporation. Pennsylvania, after de-

ducting certain fixed charges, used the balance of these installment payments to purchase Independence Trust Shares for the benefit of the certificate holders. Independence Trust Shares, issued by Pennsylvania, represented interests in a trust of common stocks of 42 American corporations deposited by Independence with Pennsylvania. Pursuant to trust agreement and indenture between Pennsylvania and Independence, Pennsylvania collected dividends and profits from the stocks and administered the trust. * * *

Respondents answered the bill and thereafter moved to dismiss it. The motions were heard with petitioners' motions for a temporary injunction and the addition of two plaintiffs. The trial judge denied the motions to dismiss, approved the addition of two plaintiffs, but reserved decision on the application for a receiver. He directed the appointment of a master to take testimony and file a report on the question of the insolvency of Independence, and enjoined Pennsylvania from transferring or otherwise disposing of the sum of $38,258.85 representing certain charges, income, and proceeds received in administration of the trust. D.C., 27 F.Supp. 763.

Pennsylvania, Independence, and the individual defendants appealed from these orders. The Circuit Court of Appeals did not expressly consider whether the appeals were premature. It thought that the Securities Act did not authorize a bill seeking equitable relief against a third party which has assets belonging to the vendor, and therefore, that Pennsylvania was not a proper party to the suit since no cause of action under the Securities Act was stated against it. It reversed all of the orders appealed from and remanded the cause with directions to allow petitioners to amend their complaint to state a claim for a money judgment at law against Independence only. 3 Cir., 108 F.2d 51. We granted certiorari because of the importance of the questions presented. 309 U.S. 648, 60 S.Ct. 715, 84 L.Ed. 1000. * * *

Respondents' motions sought to dismiss the bill because it failed to state any cause of action and because the District Court lacked jurisdiction. We hold that these motions were correctly denied.

We think the Securities Act does not restrict purchasers seeking relief under its provisions to a money judgment. On the contrary, the act as a whole indicates an intention to establish a statutory right which the litigant may enforce in designated courts by such legal or equitable actions or procedures as would normally be available to him. Undoubtedly any suit to establish the civil liability imposed by the Act must ultimately seek recovery of the consideration paid less income received or damages if the claimant no longer owns the security. Section 12(2), 15 U.S.C. § 77(*l*) (2), 15 U.S.C.A. § 77(*l*) (2). But Section 12 (2) states the legal consequences of conduct proscribed by the Act; it does not purport to state the form of action or procedure the claimant is to employ.

Moreover, in Section 22(a), 15 U.S.C.A. § 77v(a), specified courts are given jurisdiction "of all suits in equity and actions at law brought *to enforce* any liability or duty created by this subchapter". The power *to enforce* implies the power to make effective the right of recovery afforded by the Act. And the power to make the right of recovery effective implies the power to utilize any of the procedures or

actions normally available to the litigant according to the exigencies of the particular case. If petitioners' bill states a cause of action when tested by the customary rules governing suits of such character, the Securities Act authorizes maintenance of the suit, providing the bill contains the allegations the Act requires. That it does not authorize the bill in so many words is no more significant than the fact that it does not in terms authorize execution to issue on a judgment recovered under Section 12(2).

We are of opinion that the bill states a cause for equitable relief. * * * The principal objects of the suit are rescission of the Savings Plan contracts and restitution of the consideration paid, including recovery of the balance, held by Pennsylvania for account of Independence, which consisted in part of the payments alleged to have been procured by the fraud of Independence. That a suit to rescind a contract induced by fraud and to recover the consideration paid may be maintained in equity, at least where there are circumstances making the legal remedy inadequate, is well established. * * *

It is enough at this time to determine that the bill contains allegations which, if proved, entitle petitioners to some equitable relief. Whether or not they sufficiently allege or prove their right to all of the relief prayed in the bill we do not decide because the question is not before us. Hence, if the District Court had jurisdiction it was proper to consider whether injunctive relief should be given in aid of the recovery sought by the bill.

We agree with the courts below that the Securities Act confers jurisdiction of the suit upon the District Court irrespective of the amount in controversy or the citizenship of the parties. Section 22(a) provides in part: "The district courts of the United States * * * shall have jurisdiction * * * of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter." This is plainly a suit to enforce a liability or duty created by the Act. That the District Court therefore has jurisdiction is evident from the provision quoted. Accordingly, the only remaining question is whether the injunction was proper.

We hold that the injunction was a reasonable measure to preserve the status quo pending final determination of the questions raised by the bill. * * *

The injunction was framed narrowly to restrain only the transfer of $38,258.85, and the trial judge required petitioners to furnish security for any losses respondents might suffer. In view of this we cannot say that the trial judge abused his discretion in granting the temporary injunction.

We conclude that the orders granting the temporary injunction and denying the motions to dismiss were correct and should have been sustained. * * *

The decision of the Circuit Court of Appeals is reversed and the cause is remanded for further proceedings in conformity with this opinion.

Reversed and remanded.[60]

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[60] 1941, 27 Va.L.Rev. 554.

NOTE

For a discussion of civil liability under the Securities Act, see Shulman, Civil Liability and the Securities Act; 1933, 43 Yale L.J. 227; Notes, 1934, 48 Harv. L.Rev. 107; 1933, 19 St.Louis L.Rev. 76; 1935, 44 Yale L.J. 456; 1940, 50 Yale L.J. 90. See, also, Equitable Life Insurance Co. v. Halsey, Stuart & Co., 312 U.S. 410, 61 S.Ct. 623, 85 L.Ed. 920; 1941, 36 Ill.L.Rev. 117.

CADY et al. v. MURPHY.

Circuit Court of Appeals of the United States, First Circuit, 1940. 113 F.2d 988.

Appeal from the District Court of the United States for the District of Maine; John A. Peters, Judge.

Action by Clifford J. Murphy against Everett Ware Cady and others for damages for false representations in the sale of a block of stock. From a judgment of the District Court, 30 F.Supp. 466, in favor of the plaintiff, the defendants appeal.

MAGRUDER, CIRCUIT JUDGE. This appeal requires for its disposition an interpretation of § 12(2) of the Securities Act of 1933, 48 Stat. 74. The challenged judgment for plaintiff-appellee cannot stand if, as the defendants maintain, the liability imposed by § 12(2) applies only to owners of securities, selling their own property as principals.

The plaintiff is a small securities broker and dealer doing business in Portland, Maine, under the name of Clifford J. Murphy Co. For many years he had extensive dealings with the defendants, a firm of stock brokers carrying on a general brokerage business under the name of Rhoades & Company with offices in New York and Boston. Negotiation of the transaction out of which the present lawsuit arose was conducted by Murphy and Frank Lynch, the head trader of Rhoades & Company, by means of numerous telephone conversations between Boston and Portland. Early in March, 1937, Lynch persuaded Murphy to purchase voting trust certificates representing 1,700 common shares of South American Utilities Corporation (incorporated in Delaware), part of a block of 1,970 shares which had been held by E. E. Smith & Company, a small unlisted dealer in New York. The court below found that Lynch had effected the sale by misrepresentation of material facts, and further found that the defendants had not sustained the burden of proof that Lynch did not know, nor in the exercise of reasonable care could have known, of the untruth of the misrepresentations. These findings are amply sustained by the testimony and indeed are not assailed by appellants. The stock was actually without substantial value at any time. When Murphy learned the facts, he tendered back the securities to Rhoades & Company. Upon the refusal of the latter to take them back, Murphy sold the securities at a loss, and brought the present action. He has recovered a judgment for the amount he paid for the stock, with interest, less the amount realized upon the subsequent sale, with interest.

At the trial the plaintiff sought to prove that Rhoades & Company had acted as principal in the transaction; that Rhoades & Company

on its own account had bought from E. E. Smith & Company the block of 1,970 shares of South American Utilities common a day or two before Lynch sold 1,700 of these shares to the plaintiff. Murphy testified that he had never heard of E. E. Smith & Company prior to his purchase of the securities. On the other hand Lynch, who was the main witness for the defendants, offered quite a different version. He testified on direct examination, as follows:

"Q. Now will you relate what your conversation was with Mr. Murphy on the first of March? A. It was after four o'clock, March 1st, that E. E. Smith & Company called me and said he had a block of 1970 shares of South American Utilities common. He wanted to know if—

"Q. Who is he? A. E. E. Smith.

"Q. E. E. Smith was E. E. Smith and Company? A. Yes. He wanted to know if I could find a buyer for the stock. I told him I had one possibility and to hold on the line until I talked with him. I called Mr. Murphy through our Portland wire and told Mr. Murphy about this block of South American Utilities common—

"Q. Just a minute. What block did Mr. Smith speak of to you? A. A block of 1970 shares of stock.

"Q. And did you mention the number of shares to Murphy? A. I did, sir.

"Q. All right. What else did you say? A. I told Mr. Murphy that Mr. Smith had this block of stock and wanted to know if he was interested in the stock. I quoted the market to Mr. Murphy, $4\frac{1}{4}$ to $4\frac{3}{4}$. Mr. Murphy wanted to know if it possibly could be bought cheaper. I said I would be glad to try. He gave me a bid for 1700 shares of stock at $4\frac{1}{2}$. Before I had actually purchased that stock from Mr. Smith on the wire I told Mr. Murphy I had a long position in the stock which I wasn't going to sell and if I was going to buy this block of stock for Mr. Murphy I would act as agent in the transaction. He asked me what commission I would charge and I said I would charge a fair commission. We agreed on four cents a share—"

The District Court did not find it necessary to resolve the conflicting versions. It found, upon sufficient evidence, that the stock was "sold to the plaintiff by the defendants, acting either as brokers or owners". Though the evidence did not satisfy the court that Rhoades & Company acted as principals, it concluded that this was immaterial since "Section 12 of the Securities Act of 1933 applies to brokers when selling securities owned by other persons". The court found, as clearly warranted by the evidence, that Rhoades & Company, whether acting as brokers or owners, "solicited from the plaintiff an offer to buy the stock mentioned, and as a result of Lynch's solicitations and representations, the plaintiff bought the stock, paying the price named and a brokerage commission of four cents a share". This, the court thought, brought Rhoades & Company within the meaning of § 12(2) as a "person who sells a security", in view of the broad definition of "sell" in § 2(3) of the Act, which includes within the meaning of the word the "solicitation of an offer to buy". If Rhoades & Company, though not selling its own property, is a "person who sells a security" then it fol-

lows that Murphy is "the person purchasing such security from him" within the meaning of the corresponding phrase in § 12(2).

We agree with the court below that § 12(2) imposes a liability for misrepresentations not only upon principals, but also upon brokers when selling securities owned by other persons. This is not a strained interpretation of the statute, for a selling agent in common parlance would describe himself as a "person who sells", though title passes from his principal, not from him. This broader interpretation of § 12(2) is warranted by the definition of "sell" in § 2(3) and is also supported by comparison with other sections of the statute. If the security in question had been a security required by law to be registered, but as to which no registration statement was in effect, Rhoades & Company under the facts of the present case would certainly have been guilty of selling a security in violation of § 5(a) (1), and would not have come within the exemption provided in § 4(2). As a person who "sells a security in violation of section 5", Rhoades & Company would have been under a civil liability to Murphy under § 12(1). But the phrase "any person who sells a security" occurs both in § 12(1) and in § 12(2), and would seem to mean the same thing in both subsections, one of which deals with selling an unregistered security and the other of which deals with selling a security by means of misrepresentation of material facts.

It is argued that the remedy provided in § 12(2) is basically rescission, which contemplates a restoration of the status quo as between the principals to the transaction; and that Congress could hardly have intended to give this remedy to the buyer as against an agent of the seller. But the section does not use the word "rescission" nor indicate that the remedy provided is limited to rescission in the narrower sense as between the principals to the transaction. The remedy provided can be applied without difficulty to an agent of a vendor; the agent, by misrepresentations having effected a sale, is required to take over the securities from the defrauded buyer and to restore to the latter the price he paid. Even apart from statute this remedy of "rescission" in its wider sense, against the agent of a vendor, is not unknown. See Peterson v. McManus, 187 Iowa 522, 545, 172 N.W. 460 ff.; 3 Neb.L.Bull, 436, note.

At one point in its opinion the court below makes a statement of law which is broader than necessary to support the judgment rendered. It says [30 F.Supp. 466, 469]:

"Whether the seller, being a broker, himself owns the security, or whether he is acting as the agent for the owner, or for the purchaser, or for both, is immaterial. If, in the course of an attempt to dispose of, or solicitation of an offer to buy a security, he makes false statements under circumstances referred to in section 12, the purchaser is given a right of action to recover any damages he has suffered on account of the false representations."

We need not decide whether § 12(2) applies to the case of a broker acting solely for a purchaser, where the broker makes misrepresentations in the course of soliciting from the purchaser an order to buy. Even if the version of the defendants' witness Lynch is accepted,

Rhoades & Company was acting either as agent for the seller or in a dual capacity as agent for both parties, in either of which cases § 12(2) is applicable. See Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 206, 207.

The plaintiff's declaration contained a count for deceit at common law. The court below held that recovery could not be allowed on this count because the plaintiff had failed to exercise reasonable care to ascertain the falsity of the representations. In view of our conclusion that the judgment for the plaintiff may be sustained under the statute, we do not consider the correctness of the trial court's ruling on the common law court.

The judgment of the District Court is affirmed, with costs to the appellee.

McLELLAN, DISTRICT JUDGE (dissenting).

While I agree that within the meaning of the Securities Act (the material portions whereof appear in the majority opinion) one who sells as agent is a "seller" and subject to the statutory liabilities of a seller, I cannot concur in the result here reached. There was abundant evidence, which would have justified, if it did not require, a finding that the defendant acted not as agent for the seller but as agent for the plaintiff who was the buyer. The trial judge, after instructing himself that "whether the seller, being a broker, himself owns the security, or whether he is acting as the agent for the owner, or for the purchaser, or for both, is immaterial" found for the plaintiff upon the theory that the defendant was a "seller". To me, it seems, that one who acts solely as agent for the purchaser cannot be regarded as a seller and that the liability of such an agent for misrepresentations rests upon common-law principles, not upon the Securities Act which relates to misrepresentations by a seller.

The trial judge having proceeded upon a contrary view, I think justice requires that the judgment of the District Court be set aside and a new trial ordered.[61]

NOTE

There have been a number of private suits by investors to enforce the civil liabilities imposed by the Act for the sale of securities which were not registered, in violation of the Act, and for the sale of securities by means of registration statements or prospectuses containing false statements of or omitting to state material facts. The Commission has no statutory duties with respect to such suits and is not fully advised of their number or outcome. However, a search of the court records covering a period of eight years reveals that there were less than two dozen actions under all three of the civil liabilities of the Act. Moreover, so far as could be determined, not more than five suits resulted in recovery by the plaintiffs. (Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934–1944, Footnote 7, p. 13.)

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[61] Cert. den., 311 U.S. 705, 61 S.Ct. 175, 1940. Note in 1940, 54 Harv.L.Rev. 150.

(b) Criminal

PENALTIES

Sec. 24. Any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both. Securities Act of 1933, 15 U.S.C.A. § 77x.

REX v. KYLSANT.

Court of Criminal Appeal, 1931. 22 Cr.App.R. 83.

AVORY, J. The indictment in this case is under section 84 of the Larceny Act of 1861. It charged the appellant in the first two counts with publishing accounts which he knew to be false in material particulars, he being a director of the Royal Mail Steam Packet Company, with intent to deceive shareholders; and in the third count it charged him that he as a director of that company issued a prospectus inviting subscriptions to a debenture issue with intent to induce persons to subscribe or advance money to the company.

Before the appellant pleaded, an application was made by learned counsel (Sir John Simon), on his behalf, that further particulars should be given by the prosecution of the matters alleged to be false in the several documents. The learned judge adjourned his decision on that application till he had heard the opening of the case for the prosecution.

The case having been opened by the learned Attorney-General for the prosecution, at the close of that opening the learned counsel (Sir John Simon) said: "With regard to the request I made earlier in the day, I have been following closely what the Attorney-General has said, and I have his assurance that what he proposes to submit at the end, after the evidence is called, is what he has opened here. I think it is only reasonable to say that that gives me the particulars I am entitled to, and I do not wish to put the Crown to any further trouble."

In order to appreciate the effect of that concession, it is just necessary to look at one or two passages in the opening of the learned Attorney-General, where he said: "Now, members of the jury, let me make this observation to you about that document"—referring to the prospectus—"I am not for a moment going to consider detailed words and phrases. Think of the type of person to whom this was addressed. It was addressed to the prospective investor, and presumably the prospective investor of a more or less cautious type. This is not anything like a gamble. This is almost gilt-edged stock, debenture issue of the Royal Mail. Consider that you are addressing to him. See how this document strikes him and must have been intended to

strike him. What is the relevance of setting out the past at all? Why say what you were doing in the past? Why say that you have been earning—and saying it in leaded type—more than £500,000 a year, unless it be that you obviously mean anybody to draw this conclusion: 'From what has taken place in the past, you may legitimately draw an inference what will take place in the future.' It is quite obvious to every one of us that that is the object. Now could you possibly, on the facts of this case, as you know them, draw any inference as regards the future, from the fact that during these years these sums of money had been expended in dividend? That is the simple point. If this company has been throughout these years with all the figures and all the relevant facts that I have opened to you, expending millions, five to six million pounds and each year a deficit, is it not utterly dishonest—and I do not mince my words—utterly dishonest, to put a document before a prospective investor and say to him, 'Now this is what we have done in the past,' and imply to him, 'What we have done in the past is a fair indication of what you may reasonably expect we shall do in the future'?"—and following on that observation the learned Attorney-General quoted from the opinion of the late Lord Halsbury in the case of Aaron's Reefs v. Twiss, reported in 1896 Appeal Cases to which we shall have occasion to refer later.

So bearing in mind those passages of the opening, and the concession which was made by the learned counsel that that supplied him with sufficient particulars of this indictment, the issue before the jury was defined, and the trial on that issue proceeded. We are not saying, of course, for a moment, that that concession about particulars in any way precluded the learned counsel from his further argument on the proper construction of section 84 of the Larceny Act.

In the result, the appellant was acquitted on counts 1 and 2, and he was convicted upon count 3. In case it should be thought that there is any apparent inconsistency in the verdict of the jury, we think it right to say that with regard to counts 1 and 2 the jury may have thought that existing shareholders had some information from the published accounts which the outside public had not, particularly in view of the fact that in the Profit and Loss Accounts for those years and previous years there had been some indication of what was called an "adjustment of taxation reserves," a somewhat abstruse expression which gave rise to considerable discussion during this case.

Now coming to count 3, on which the appellant was convicted, the prospectus in question was issued on June 29, 1928. The subscription list was opened on July 3 and closed on or before July 4. It was an issue of 5 per cent. debentures at £92 10s., and in fact it was oversubscribed.

The material portions of that prospectus are first of all the statement of the capital issued and fully paid, of the existing Debenture Stock, and of the Reserve Fund of £1,450,000, and the Insurance Fund of £1,311,755; and on page 2 of the prospectus, after setting out the history of the company and stating that the object of the issue was to provide additional capital for a new freehold building and for the general purposes of the company, it proceeded: "The interest on

the present issue of Debenture Stock will amount to £100,000 per annum. Although this company, in common with other shipping companies, has suffered from the depression in the shipping industry, the audited accounts of the company show that during the past ten years the average annual balance available (including profits of the Insurance Fund), after providing for depreciation and interest on existing Debenture Stocks, has been sufficient to pay the interest on the present issue more than five times over. After providing for all taxation, depreciation of the fleet, etc., adding to the reserves and payment of dividends on the Preference Stocks, the dividends on the Ordinary Stock during the last seventeen years have been as follows:"—and then it sets out a table of the dividends paid from the year 1911 to the year 1927 inclusive, those dividends varying from 5 up to 8 per cent., and down on one occasion in the year 1926 to 4 per cent., in 1927 again showing 5 per cent.

One purpose for which this issue was made appears to have been to pay off an overdraft at the bank of £500,000, which had been agreed with the bank in the year 1926. That overdraft, granted in 1926 for a period of three or six months, had been renewed from time to time for short periods on the promise of this new issue being made, out of which the bank hoped to be paid the overdraft.

We now come to consider the grounds of appeal in this case, which are: (1) That there was no evidence that the appellant made or published or concurred in making or publishing a written statement which was false in any material particular; (2) that there was no evidence that he made or published that prospectus knowing it to be false in any material particular; and (3) no evidence that he made or published that prospectus, which he knew to be false in a material particular, with intent to induce persons to entrust or advance property to the Royal Mail Steam Packet Company. The third ground is immaterial, because it is now admitted that if it was published, and if it was false, and known to be false, there can be no question that it was published with intent to induce persons to entrust or advance property to the company.

These grounds of appeal were supplemented by the further ground that the learned judge at the trial had misdirected the jury and that he ought to have directed them that there was no evidence that the prospectus contained any false statement; and it then sets out certain extracts from the summing-up of the learned judge, which, it is complained, were in fact wrong, amounting to a wrong direction in law. These are long extracts, and they are, as I have said, only extracts. It will be necessary to refer to some other passages in the summing-up to which exception is not specifically taken.

These are the passages which are complained of, in which the learned judge said, referring to the section: "These are the words which it is said require some consideration, and I confess I think they do. It is these words 'make, circulate, publish or concur in making, circulating or publishing any written statement or account which he shall know to be false in any material particular.' What exactly does that mean? The conclusion that I have arrived at is this, that it is not limited to a

case where you point to a written account or written statement and say: Here are certain figures, here are certain words which are false. I think that is to narrow unduly the words 'in any material particular.' It is perfectly true that in a criminal act, which carries with it the penalties of the criminal law, the Act must be strictly construed, but it must be reasonably construed, and in my judgment to construe it in that way would be to shut out a type of fraud in connection with written documents or written accounts which may be of the utmost importance, and that is the type of fraud which may be found in a document, not fraudulent in the sense of what it states, but in the sense of what it conceals or omits. You may have a definite and positive falsehood in a document, and then when that obviously is the case, where in respect of the words pertaining to that specific falsehood you could say, 'This is a material particular'—it is for the judge to say what is material, but clearly I am taking a case, as indeed in this case, where what is alleged is definitely material. It may be said where you have specific words or figures containing a falsehood which you can put your finger on and say 'it is false in a material particular, and it is in this material particular,' but I think the language which is used means more than that, according to its reasonable interpretation. It will cover the case where you have a written statement which is false, not in any specific words or any specific figures which it contains, but which is false in the way in which a document may be fraudulent, namely, where you may take every word and every figure and say, 'Now there is nothing false about this, there is nothing false about that,' but the document as a whole may be false—the document as a whole may be false not because of what it states, but because of what it does not state, because of what it implies. Of course, that type of falsity, which is indeed the type of falsity in the main in question here, is more difficult to establish than the case where you can point to a specific false word in a sentence, because where the falsity consists in a fraudulent desire to create a false impression, while keeping accurately to the limited facts which appear in the document, where the falsity consists of that, you have to show affirmatively that there was a deliberate intent to create a false impression. If you have a definite falsehood, that speaks for itself. A man who has told a definite falsehood or written a definite falsehood may perfectly well be able to show that though it was false he did not know that it was false, or in certain cases, that he knew it was false, he did not intend to deceive anybody, but made a false statement, an inaccurate statement thinking that it was substantially true, though he knew all the facts which ought to have told him that it was untrue. That is a much simpler case than where you have a case in which a written statement is alleged to have been false in the sense that it was concealing true facts. Then you have to show before you can get any further at all that it was a deliberately concocted instrument, the instrument of a definite scheme to defraud or to deceive, as the case may be, and therefore in order to prove a case of fraud of this latter type, fraud as it were by concealment, the intent of the parties must be established at the outset. But to construe section 84 so as to exclude from its ambit that type of fraud in a writ-

ten statement of account is, in my judgment, to limit unduly the scope of the enactment, to exclude from it some of the most important types of false documents which in this class of case may have to be dealt with and—which, I think, is the guiding feature—to do an injury to the language; the language must be construed reasonably, according to its natural meaning, and in my view, having regard to the whole of this section, its purpose and its character, I think the construction which I have given to it is the true construction."

Then there follows another long extract from the summing-up of the learned judge, which it is not necessary to read in full, but which contains this passage, and it is a part of the summing-up which is complained of as being wrong in law, amounting to a wrong direction, in which the learned judge said: "Was the form which was adopted here, and which erred by reticence, deliberately adopted with an intention to deceive? Was it, not merely a case of prudent and well-advised reticence, but a case of malignant, deliberate, wicked and treacherous deceit in order to defraud? This is one of those difficult cases, but not impossible cases, which have occurred from time to time in the course of company transactions, where a document has been put forward in order to be acted upon (prospectuses and other things) and put forward in such a form that though it stated every fact correctly fact by fact, everything was correctly stated by the card, and yet the true effect of what was said was completely false and completely misleading. Now that result might be achieved with the best of intentions, and by a man who, while his mind was fixed on attaining his object, and floating an issue, and while he was in a sense thinking of what was best to achieve that object, was not thinking and was not conscious to himself that he was going to mislead people and that he was going to induce them to subscribe to the issue under a belief which was completely false and completely delusive. People sometimes say to themselves, 'Well, this is all I need tell; I will only tell as little as it is necessary, but what I will tell I will tell quite accurately, and then I can quite fairly and honestly leave it to the person who reads this prospectus to make up his own mind.' That is to say, he may have no dishonest intent, he may have perhaps no real consciousness that what he is doing is delusive and mischievous. He may, of course, be, in some cases, if he is under a legal obligation to disclose all the relative facts, liable to a civil action. Here you are not concerned with the civil liability, you are concerned with the offence under this Act as stated in the indictment."

Then he reads again the charge in the indictment, and he proceeds: "Of course that means that he fraudulently and with wicked intent and deliberately published that with that wicked design of defrauding. Now that, again, is a question entirely for you. Do you think that this was a document which by accident or design innocently or criminally did mislead people? Do you think that people invested on the faith of this document, and in the belief that it contained all that it ought to contain, whereas if they had been told the true facts they would not have put money into this concern at all, because they would have wanted some guarantee of the earning capacity of the company?"

That passage that I have just read is followed by a further passage, in which the learned judge said: "As we all know, though a debenture-holder in a sense is secured, indeed, in fact is secured on the assets which, in certain events, he may realise, which he may enter into possession of in certain events, yet the man who takes debentures is not thinking of that; he wants to take a debenture which is secure as regards the assets and which is also likely to be a useful debenture to him and yield him an income year by year, an income which will come in due course from the earnings of the company, and therefore it seems common-sense that a man would not invest in a company at a time when it had a record of unfruitful working for some years past, however much it may have had of the special credits to keep it going and to provide dividends. That may be perfectly true, but, as I say, you have to go on a step further, you have to consider the really anxious aspect of this account, you have to consider, assuming that you are satisfied that it was in truth and in fact a misleading document, was it deliberately concocted, was it deliberately put together with the intention of stating certain things and not stating other things so that anyone reading what was said, not knowing what was not said, would be deluded and deceived about the true nature of the company? It is said by Lord Kylsant that he knew what the position had been, he knew what the earning capacity had been, and he would say, 'Well, there is a well-secured asset here'; and then, 'We are in the trough of the wave now or we are just coming from the trough of the wave, and things will soon improve again, and then all will be well.' That is a matter which you will have to take into account. You will bear in mind that it is always possible to be wise after the event, but on the other hand you will consider whether there was such necessity at this time for obtaining further money as to form a motive for deceit. Even that will not be enough. You must satisfy yourself, before you can find Lord Kylsant guilty, not only was there a motive, but was there an actual intention, a deliberate and criminal intention, to obtain from the investor money which he would not have parted with if he had known the true facts. It is not a question here whether what was done was done within strict business lines. It is not a question whether what was done was strictly honourable. It is a question whether an offence was committed under this penal section which carries with it in the event of conviction the consequences which invariably flow from conviction under the criminal law."

Then a little lower down he adds these words: "In the main it is quite obvious that this is, letter by letter, word by word, an accurate document, so far as it goes, and it can only be found"—(probably it should read "It can only form")—"the basis of a charge of fraud if you are satisfied, as I have said more than once, that there was this deliberate and wicked and criminal intent to concoct a false and misleading document."

It is convenient now to refer to one or two authorities which in our view support the view of the law expressed by the learned judge in his summing-up. In the case of Gluckstein v. Barnes, reported in 1900 Appeal Cases, at page 250, Lord Macnaghten said, giving his opinion in

that case, which concerned a company and its prospectus: "My Lords, it is a trite observation that every document as against its author must be read in the sense which it was intended to convey. And everybody knows that sometimes half a truth is no better than a downright falsehood." Then he proceeds to deal with the facts of that particular case.

* * *

In the present case we find that the learned judge on more than one occasion specifically called the attention of the jury to the distinction which they must bear in mind between a possible civil liability and a criminal liability, and in the opinion of this Court there was ample evidence upon which the jury could come to the conclusion that this document, the prospectus, was false in a material particular, in that it conveyed a false impression, the falsity in this case consisting in putting before intending investors as material upon which they could exercise a judgment about the existing position of the company, figures which apparently disclose the existing position but in fact conceal it. In other words, the document implied that the company was in a sound financial position, and that a prudent investor could safely invest in its debentures. This implication arises particularly from the statement that the dividends have been regularly paid over a term of years, although times have been bad, a statement which is entirely misleading when the fact that they were paid not out of current earnings but out of earnings in the abnormal war period, is omitted.

The further question is whether there was evidence upon which the jury could properly find that the appellant knew that this document was false. If there was evidence that the document was false in the particulars already indicated, there was ample evidence upon which the jury could find that the appellant knew of its falsity, knowing as he did of the means by which the dividends had been paid; and it is not and cannot be disputed that the prospectus was published with the intent to induce persons to entrust or advance money to the company, which was sufficient to satisfy the section. But the learned judge told the jury, in the passage that I have already read, that upon this third count also they must find the intention to defraud, and he repeated this, after the jury had retired and sent their written question to him. In these circumstances the jury must be taken to have found that what was done in this case was done with an intent to defraud.

In the result, we come without hesitation to the conclusion that in the summing-up, regarded as a whole, there was no misdirection, that there was ample evidence upon which the verdict of the jury can be supported, and that this appeal must be dismissed.

I intended to add, with reference to what took place after the jury had retired and asked a question of the learned judge, that in the opinion of the Court the direction to the jury by the learned judge was too favourable to the accused, and that he ought to have told them that on this third count it was sufficient if they found an intent to induce persons to subscribe or advance money to the company.

Appeal dismissed; leave to appeal against sentence refused.

NOTE

(A) *Contempt:* Where a decree had been entered enjoining the sale of unregistered securities it was held to be criminal contempt for the persons enjoined to solicit "contributions" for their plan since "* * * it was the same false and fraudulent program appearing in a new garb." Davis v. Securities and Exchange Commission, 109 F.2d 6, C.C.A.Ill.1940, cert. den. 309 U.S. 687, 60 S.Ct. 889, 84 L.Ed. 1030, 1940 (the injunction here involved was the one issued in Securities and Exchange Commission v. Universal Service Ass'n, supra, (D), p. 746).

(B) *Perjury*: A person who testifies falsely as to material facts in an ex parte investigation made by the Commission, even though the information be volunteered, may be indicted and convicted for perjury. Woolley v. United States, 97 F.2d 258, C.C.A.Cal.1938, cert. den. 305 U.S. 614, 59 S.Ct. 73, 83 L.Ed. 391, 1938.

For a discussion of the penal provisions of the Securities Acts, see Herlands, Criminal Law Aspects of the Securities Exchange Act of 1934, 1934, 21 Va.L.Rev. 139; Herlands, Criminal Law Aspects of the Securities Act of 1933, 1933, 67 U.S.L. Rev. 562, 615; MacIntyre, Criminal Provisions of the Securities Acts and Analogies to Similar Criminal Statutes, 1933, 43 Yale L.J. 254; Note, 1938, 23 Wash.U.L.Q. 251.

NOTE

TYPES OF CASES

The frauds and other statutory violations encountered by the Commission in its investigations under the various Acts are as varied as human imagination and ingenuity can contrive. Many of the cases have entirely novel features or present a new "twist" of one kind or another. As a rule, however, the cases fall into certain broad patterns, set out below:

(1) *Express Misrepresentations.* The most common type of fraud is the simple promotion based upon express misrepresentations, which does not involve any of the complex and refined devices not infrequently employed in securities schemes. The promotion of mining ventures, usually gold mines, and the sale of oil and gas interests frequently present opportunities for perpetration of this type of fraud. Thus, in the case of United States v. Samuel J. Mustain, et al. (S.D.N.Y.), three individual defendants and four corporate defendants, among the latter a company known as Continental Securities Corporation, were convicted in connection with fraudulent sales of oil royalty securities. In the course of such sales it had been falsely represented to investors that they were certain of a definite income for life if they purchased the oil interests; that they could have their money back at any time if not satisfied; that their principal would be fully returned within two and one-half years; and that the securities were being purchased by banks.

The alleged fraudulent promotion is also encountered in the exploitation of so-called inventions. Thus, convictions have been obtained in promotions of a new type of revolving top for commercial buildings, United States v. Charles Thelman Rice, et al. (D.N.M.), and of a vessel said to be capable of attaining speeds of 80 to 100 miles per hour, United States v. Mark L. Gilbert, et al. (S.D.Ohio). An indictment is currently pending with respect to a pinless diaper promotion. United States v. Philip A. Frear, et al. (D.C.)

In a number of the mining company cases, securities have been sold by persons resident in Canada and operating from across the border without compliance with the statutes of this country. The Commission has been cooperating with the State Department and the Department of Justice in efforts to secure a treaty with Canada which would permit extradition from Canada of persons violating the federal

securities laws and cognate statutes. The treaty was ratified in the United States Senate in 1942, but to date it has not been ratified by the Canadian Parliament.

(2) *"Ponzi" Schemes.* This type of case, a perennial favorite of the securities swindler, involves the payment of "profits" or "dividends" out of capital. The apparent success of the venture makes the investor susceptible to further investment, a process sometimes colloquially described as "reloading." The "Ponzi" system is a recurrent motif in fraudulent small loan company ventures. Illustrative of these cases is United States v. Dewitt T. Simpson, et al. (S.D.Ga.), involving Standard System Investment Corp., a holding company which had obtained control of a number of industrial loan companies operating in various cities in Georgia. Prominent business and professional men who were not aware of the scheme were persuaded to act on the board of directors. Actual control, however, was exercised by Simpson and two associates, who made fictitious book entries and paid dividends out of capital, despite lack of real earnings. All three were convicted in 1943, in Savannah, Georgia, for violations of the fraud provisions of the Securities Act of 1933, and for other statutory offenses.

The "Ponzi" method is sometimes employed in vending machine promotions. Thus, in United States v. Maurice A. Levine, et al. (D.Mass.), cigarette and peanut vending machines were sold to investors under a lease-back arrangement whereby the promoters were to operate the machines for the investors on a profit-sharing basis. "Profits" were paid periodically out of capital until the entire structure collapsed, leaving the victims with machines worth far less than they had paid for them. Six defendants pleaded guilty in this case.

(3) *"Switch" Schemes.* Some individuals sell their victims *bona fide* securities, thereby cultivating their trust and confidence, and then persuade them to dispose of their holdings and to substitute securities which are frequently worthless. In other cases the scheme is to obtain lists of persons previously sold a security and then induce them to accept a new security in exchange. This "switch" device was one aspect of the fraudulent scheme involved in United States v. John Factor, et al. (N.D.Iowa), a bottling contract case, in which John (Jake the barber) Factor and a group of confederates, operating through United Bottling and Distributing Company, a Delaware corporation, defrauded some 250 investors to the extent of an estimated $1,000,000. The owners of whisky warehouse receipts were induced to exchange them for bottling contracts, by the terms of which United Bottling was to hold the whisky until it matured, see to its bottling and distribution, and transmit the profits, less a stated service fee, to the investors. In a number of instances, persons who did not own whisky warehouse receipts were sold such receipts and then "switched" into bottling contracts. United Bottling was a mere paper organization, and the whisky warehouse receipts were sold or hypothecated as soon as possession was obtained. Eleven defendants pleaded guilty and received substantial prison sentences, Factor himself being sent to the Federal penitentiary at Leavenworth for a term of ten years.

(4) *Front Money Schemes.* This device involves the exploitation of small business enterprises upon a promise to procure for them needed financing. Perhaps the most important of the "front money" cases developed by the Commission was that of United States v. E. J. Hill, et al. (N.D.Ohio), stemming from an intensive investigation conducted in cooperation with the Post Office Department and the Department of Justice. It was disclosed that, for approximately six years, hundreds of enterprises or prospective entrepreneurs had been victimized by the operations of this racket. The victims had been induced to pay advance fees estimated to total some $1,000,000 for various services in connection with incorporation, registration, and the preparation of sales literature. This was accomplished by false and misleading representations as to the ability of the respondents to secure financing and capital upon the payment of an advance fee; actually, the investigation failed to disclose a single instance in which a share of stock had been sold or a dollar of

capital secured for the victims. Ten persons were convicted in this case. (Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934–1944, pp. 143–145.)

B. PURPOSE AND SCOPE OF "BLUE SKY" LAWS

(Prior to enactment of the Securities Act, various state laws were in force dealing with the problem of sales of securities to the public. The following material merely indicates the continuing effectiveness of such statutes, and the necessity for taking them, as well as the Securities Act, into consideration.)

STATE CONTROL OF SECURITIES

Sec. 18. Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person. Securities Act of 1933, 15 U.S.C.A. § 77r.

NATURE AND SCOPE OF THE STATE LAWS [1]

Securities laws have been enacted in this country in all of the states except Nevada. The various laws may be roughly classified as follows: (1) the "fraud" type of law, which does not require either "qualification" (i.e., registration or approval) of securities or "licensing" of security dealers, but, in general, merely provides penalties for fraud and authorizes injunctive proceedings to prevent fraud;[2] (2) the "licensing" type of law, which, in general, requires dealers in securities to be licensed, but does not require that securities be qualified;[3] (3) the "inspection" type of law, which, in general, requires that securities be qualified, but does not require that dealers be licensed;[4] and (4) the "licensing and inspection" type of law, which requires both that securities be qualified and that dealers be licensed, and which is the most common type of law.[5]

The fraud type of law raises no problem so far as ordinary, legitimate transactions in securities are concerned, whether such transactions are local or interstate in character, since affirmative action is not required to be taken as a condition precedent to sales of securities. [Smith, "State 'Blue-Sky' Laws and the Federal Securities Acts," 1936, 34 Mich.L.Rev. 1135, 1137.]

In the licensing of dealers, required in most states, several problems arise, the initial one, of course, being "who is a 'dealer'?" the typical definition is well illustrated by the Michigan statute as follows:

"The terms 'dealer' or 'broker' shall include every person and every company,

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[1] Author's footnotes omitted.

[2] Delaware, Maryland, New Jersey and New York. Both New York (since 1931) and Maryland (since 1937) now require the licensing of dealers.

[3] Connecticut, Kentucky, Maine, Montana, New Hampshire, Pennsylvania, Rhode Island and Vermont. The issuer of securities himself, however, is not ordinarily permitted, under this type of statute to sell his own securities until they have been definitely approved by the State.

[4] E. g., Nebraska.

[5] Arizona, Arkansas, California, Colorado, George, Illinois, Indiana, Idaho, Iowa, Massachusetts, Mississippi, Minnesota, Missouri, Ohio, Oregon, North Carolina, South Dakota, Tennessee, Texas and Wisconsin. The Uniform Sale of Securities Act (see Handbook of National Conference of Commissioners on Uniform State Laws, 1929), requiring both the registration of securities and the licensing of dealers, has been adopted in substance in four jurisdictions: Alabama, Florida, Michigan and Hawaii (ibid., 1939).

firm, trust, partnership or association, incorporated or unincorporated, other than a salesman or issuer, that engages either wholly or in part in the business of selling, offering for sale, negotiating for the sale of or otherwise dealing in any securities issued by another or by others, or underwriting, purchasing or otherwise acquiring such securities from another for the purpose of reselling them or of offering them for sale, or offering, buying, selling or otherwise dealing or trading in securities as a broker, agent or principal, or who deals in futures or differences in market quotations of prices or value of any securities or accepts margin on purchases or sales or pretended purchases or sales of such securities." Comp. Laws 1929, ch. 188, Sec. 2(g), as amended.

Certain exceptions, however, are commonly made to the statutory definitions. Thus if an ordinary investor who has acquired securities for his own account wishes to dispose of his holdings, he will not be required to comply with the statute. Cf. Opinion of Attorney General of Indiana, Dec. 23, 1925. Again, persons engaged in selling exempted securities may be excused from obtaining licenses, although ordinarily they would be deemed "dealers." See Opinion of Attorney General of Calif., Oct. 21, 1931. Usually, as in the Michigan statute, no distinction is made so far as regulation is concerned between "dealers" and "brokers," although some states use the latter rather than the former term.

The application for a dealer's license is made to the local regulatory body, usually a specially created securities commission or a branch of the state banking department. (See II C.C.H., Stocks and Bonds Law Serv., Chart I, p. 6503.) The information which the application is required to contain varies greatly from one state to another, this result being encouraged by the fact that the exact information required is largely a matter of administrative determination. An examination of the Illinois form of application, somewhat typical of those generally used, will reveal the broad scope of the investigation made before licenses are issued. The cost of a dealer's license ranges from $25 (Arizona, California, Illinois) to $100 (Arkansas, Michigan), and in most states must be renewed annually. In many states there is the additional requirement that the dealer furnish a bond,[6] made payable to the People of the state and ordinarily of $5,000 in amount. These bonds are for the protection of persons injured by violations of the Blue Sky Laws, and in at least one state (California) the securities commission may require the furnishing of a new bond as soon as an action is begun on the old one.

Agents of dealers, referred to in some statutes as "salesmen," are also commonly subjected to regulation. Thus they must also obtain licenses before selling securities, although the information required in the application is considerably less than that required of dealers, and the fees are also less. In addition a bond is sometimes required. (E.g., Alabama, $500.)

As to what securities must be registered under the particular state law, the first point of reference, as always, is the statutory definition of that state. The Michigan law [Comp.Laws 1929, ch. 188, sec. 2(c)] provides as follows:

"The term 'security' or 'securities' shall include any note, stock, treasury stock, bond, debenture, evidence of indebtedness, pre-organization certificate or pre-organization subscription, transferable certificate of interest or participation, certificate of interest in a profit-sharing agreement, certificate of interest, units and/or shares in an oil, gas, or mining lease, oil or gas well, collateral trust certificate, any transferable share, investment contract, or beneficial interest in or title to property or profits, or any other instrument commonly known as security." [Comp. Laws, 1929, ch. 188, Sec. 2(c), as amended.]

Such a definition, it will be seen, is extremely broad in its effect. Indeed, there have been comparatively few situations where litigation was necessary to determine whether or not the contract involved constituted a "security." The ques-

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[6] Alabama, California, Florida, Iowa, Illinois, Michigan, Mississippi, Missouri, North Carolina, Ohio, Oregon, Tennessee, Texas and Wisconsin.

tion with which a lawyer planning a transaction will be concerned is whether or not that transaction or the securities involved therein fall within any of the express statutory exemptions. Although the laws of each state must be studied for the exact exemptions granted by that state, a few of the more commonly found ones are:

Exempt transactions: Bona fide isolated sales by individuals, distribution of stock dividends to stockholders, judicial sales, public auction sales, sales by pledge holders or mortgagees, sales to banks, trust companies and insurance companies.

Exempt securities: securities issued by the United States, states and territories, by foreign governments and subdivisions thereof, by national and state banks, by building and loan associations, insurance companies, public utilities, savings banks, trust companies, corporations organized under acts of Congress or domestic corporations, cooperative associations, non-profit and eleemosynary associations, under the federal Farm Loan Act, commercial paper issued in the regular course of business, conditional sales contracts, public utility equipment trust certificates, stock subscriptions, securities issued to security holders in the course of merger or reorganization, personal and real property mortgage bonds and notes, and securities listed on specified stock exchanges. See II C.C.H., Stocks and Bonds Law Serv. Chart IV, p. 6525.

As to the securities other than those which escape regulation by means of the various exemptions, approval of the local regulatory body must be obtained before they are sold. In a number of states (e.g., Minnesota, Missouri, Ohio, Oklahoma and Oregon) this can be accomplished by one of two procedures, "qualification" or "notification." [7] The latter is a comparatively simple device expressly reserved for certain types of securities. (In other states these same securities may be found within the class of exemptions.) The only information required in a "notification" is the name of the issuer, the amount and price of the issue, a brief descriptive statement of the issue, and a brief statement of the facts which show that the issue is entitled to notification. The process of "qualification" [8] is a more difficult matter, and is carried out, as in "notification," by either the underwriter or the issuer. An idea of the large amount and diversity of information required can best be gained by a study of an application form. The fees charged for "notification" or "qualification" usually vary depending upon the total proposed sale price of the issue, but a minimum ($10–$25) and a maximum ($100–$500) prescribed by statute fix the upper and lower limits.

Once an application is filed, the administrative board charged with supervision of security issues makes an examination into the information set forth, and may shortly thereafter grant a permit for the sale of the particular issue or may require furtner data to be furnished before such approval is given. Sometimes a hearing will be necessary upon certain matters and in such case the administrative body must give notice to the applicant. If permission is refused, the applicant may thereupon take advantage of statutory provisions and demand a hearing upon his application.

State regulation, however, does not cease even after authority has been given for the sale of the securities. The blue sky laws often provide for examinations by

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[7] Illinois at an early date, met the problem of different classes of securities in an interesting manner. The Blue Sky law of that state divides securities into six classes: "A", "B", "C", "D", Investment Contracts and Investment Trusts. The first two classes, covering securities issued by the United States, states, banks, trust companies and other such "gilt-edged" securities ,are exempt from regulation. Class "C" securities may be registered by a simple process, similar to "notification," while Class "D" securities must be qualified and must bear in bold face type the words "SECURITIES IN CLASS 'D'. THESE ARE SPECULATIVE SECURITIES." The constitutionality of the Illinois act was upheld in Stewart v. Brady, 300 Ill. 425, 133 N.E. 310, 1921.

[8] E. g., Colorado, Indiana, Massachusetts, Michigan, Minnesota, Mississippi, and Nebraska.

the board after the sale has begun, and if facts are found to have been misrepresented, or certain other specified defects in the application appear, the board has the power to withdraw its permission, thus making any further sale a violation of the statute. In some states the issuer must file periodic reports with the administrative body, a procedure similar to that adopted under the Securities and Exchange Act of 1934.

ASSOCIATED GAS & ELECTRIC CO. v. PUBLIC SERVICE COMMISSION.

Supreme Court of Wisconsin, 1936. 221 Wis. 519, 266 N.W. 205.

FOWLER, J. The plaintiff Associated Gas & Electric Corporation petitioned the Public Service Commission of Wisconsin for registration of bonds it was issuing. The commission denied the application. The appellants brought action in the circuit court to review the order of the commission. The court confirmed the order.

The appellants contend, (1) that registration of the bonds was not necessary; and (2) that if it was registration should have been granted.

The plaintiff Associated Gas & Electric Company, hereinafter referred to as the "Company," owns all the stock of the plaintiff Associated Gas & Electric Corporation, hereinafter referred to as the "Corporation." The Company had outstanding debentures to the amount of $264,000,000 bearing fixed interest rates and maturing at different times. Its income is practically all derived from the Corporation. The Corporation's income is derived from its subsidiaries. During the period of the general business depression commencing about 1931, the income of the numerous subsidiaries of the Corporation fell off, and thus the income of the Company fell off to a point where the Company claims it became likely that it would default in its debenture obligations and be forced into receivership. To avoid this, the two corporations devised a plan of converting such portion of their interest-bearing debentures into income debentures, rearranging dates of maturity and rates of interest of the new interest-bearing debentures, and procuring exchanges of the old securities for the new, so as to enable the Company to avoid defaults and escape receivership. Some holders of the debentures of the Company were residents of Wisconsin. To enable the Company to negotiate with Wisconsin residents for exchange of the new securities for the old, the Corporation filed with the Public Service Commission of the state, which will hereinafter be referred to as the "commission," a petition for a "permit to sell" the new bonds. An exchange is a sale within the terms of the statutes governing the granting of permits to sell. Securities are "registered" when a permit to sell them is granted, and the term "registration" is hereinafter used as synonymous with the word "permit" and the phrase "issuance of a permit." The commission denied registration, except as to one of the three classes of the new bonds proposed.

The proposed plan provided for giving the debenture holders the choice of three options: (a) The debenture holders might take in exchange for their debentures new debentures due in 1973 to the amount

of fifty per cent of the old bonds surrendered bearing the same rate of interest as the old bonds. The new debentures were not those of the Company, but of the Corporation. The amount of these new bonds to be issued was limited to $50,000,000. The new bonds might be exchanged within ten years from June 15, 1935, to income debentures of the Corporation due in 1978, of the kind covered by option (b) and of the same amount as if originally accepted under option (b). Option (a) was terminable at any time. The bonds were to be subject to $10,000,000 of outstanding bonds of the Corporation. Registration of these bonds was denied, but as the amount to be issued is now fully subscribed by nonresidents of Wisconsin, the question whether registration of them by the Wisconsin commission was necessary is moot.

(b) Debenture holders might take for their old bonds debentures of the Corporation to the amount of the bonds exchanged with interest payable out of earnings after payment of the obligations of the Corporation. The bonds were cumulative in nature. Five and a half and five per cent bonds were reduced in rate one per cent, four and a half reduced to three and three-quarters per cent, and four per cent reduced to three and a half per cent. These bonds were to be subject to the $10,000,000 of outstanding bonds of the Corporation.

(c) Debenture holders might take sinking-fund income debentures of the Company, due in 1983, of the same amount as the debentures surrendered, with interest at the same rate, cumulative, additional interest to be added under specified conditions which need not be stated, as the commission ruled that registration of these bonds was not necessary on the ground that the exchange would merely be one form of bond of the Company for another form of bond of the same Company of the same denomination.

As the plaintiffs are not prejudiced by the ruling of the commission respecting exchanges of bonds under options (a) and (c), we will limit our consideration of the case to the questions arising respecting option (b), which are above outlined under headings (1) and (2).

(1) Whether any permit was necessary to authorize exchanges under option (b) depends on the terms of the statutes exempting certain classes of bonds from the restrictions respecting the negotiations of securities. The constitutionality or validity of the statutory regulations respecting registration is not attacked. The only question raised is respecting the construction of the statutes relating to exemption from those regulations. The statute which the plaintiffs most strenuously contend exempts the bonds to be transferred under option (b) from the permit regulation is sec. 189.05(6), which is as follows:

"189.05 *Exempt sales.* Except as hereinafter provided the provisions of this chapter prohibiting the sale of securities unless registered by the commission shall not apply to the following transactions: * * *

"(6) The sale of securities when made by or on behalf of a vendor not the issuer thereof who, being a bona fide owner of such securities, disposes of his own property for his own account, provided such vendor at the time of such sale is not engaged either wholly or in part in the business of selling securities and such sale is not made, directly or in-

directly, for the benefit of any other person or company, or for the purpose of violating or evading any provision of this chapter."

The meaning of the word "sale" in this statute is fixed by sec. 189.02(6), Stats., as covering "every disposition, offer, negotiation, agreement or attempt to dispose of a security * * * and every exchange of a security for property." The word "vendor" is not defined in the statute, but it is obviously used as referring to a person effecting a "sale," and would thus cover the party negotiating or attempting to negotiate the transfer of securities in exchange for property.

As the matter of registration first came before the commission, and as matters stood when the commission first determined the matter, only the Corporation was before the commission, and the right of the Corporation to registration of bonds issued by itself was the only question involved. The Corporation was, within the language of the statute, a "vendor" proposing to "sell" bonds issued by itself, and was not exempted from the provisions of sec. 189.06 (1), Stats., requiring registration before the bonds could be "sold."

After the commission first denied the Corporation's application, the Corporation asked for a rehearing, which was granted, and it was then first contended that it was the Company that was in fact disposing of the bonds, and it was disposing of them as the owner thereof in good faith within the meaning of sub. (6) above quoted. The theory upon which it claimed to be such owner is that as part of the plan of reorganization the Corporation had declared a dividend of $265,000,000 to the Company, and in payment of the dividend had delivered to the Company the new bonds covered by the options. Said sub. (6) provides that to exempt from registration the vendor must be a "*bona fide* owner" of securities, disposing of "his own property for his own account," and that the sale contemplated cannot be made "directly or indirectly for the benefit of any other person or company, or for the purpose of violating or evading any provision of this chapter." The commission found that the Company was not a *bona fide* holder of the Corporation bonds within the meaning of this statute. This conclusion was correct. The Company, if it had possession of the Corporation's bonds at all, did not hold them as an absolute owner. It could not lawfully sell them to the general public. Its disposition of them was restricted. It could part with them only by exchanging them for its own bonds of like denomination. It could not deliver one of them to a resident of Wisconsin except in exchange for one of its own bonds of like denomination. This was not *bona fide* ownership. Moreover, the exchange was at least indirectly for the benefit of the Corporation, and within the language of sub. (6) was thus indirectly if not directly "for the benefit of any other [another] person or company." The exchange of the bonds was manifestly for the benefit of the Corporation, for without it the Corporation could not pay the dividend it had declared. The Corporation was the one that was disposing of the bonds to the public as a means of paying its dividend. It was to pay its dividend with bonds of the Company and attempting to effect the contemplated exchanges for the purpose of procuring Company bonds with which to pay it. That was the Corporation's own view of the matter, as is evidenced by the fact that

it was the Corporation that applied for the "permit to sell" the bonds in the first instance. In the proceedings for registration, up to the time the permit was first denied, no suggestion of Company ownership was made. The belated contention of ownership by the Company involves the concluding condition of sub. (6)—that the vendor shall not be making the sale "for the purpose of violating or evading any provision of this chapter." The contention of Company ownership was presented for the purpose of evading the statutory provisions requiring registration by the Corporation as prerequisite to disposition of the bonds.

It is also contended that the Company is entitled to exchange the Corporation bonds without registration under the portion of sec. 189.05 (15), Stats., declaring that the provisions of the statutes prohibiting the sale of securities without registration shall not apply to "the issue in good faith of securities by a company to its security holders, or creditors, in the process of a *bona fide* reorganization of the company made in good faith, or the issue in good faith of securities by a company, taking over substantially all the assets and continuing the business of another company, to the security holders or creditors of such other company." But the Corporation does not come within this language because the new bonds are not "issued" to "its security holders," but to the security holders of the Company; and the Company does not come within the language because it is not "a company taking over * * * the assets and continuing the business" of the Corporation. The Corporation continues the business, not the Company. It is suggested that the two corporations are so connected that the one is the other. If so, why the other? But even so, on this hypothesis, the language would not apply because the Company would not be continuing the business of another company, but merely continuing its own.

It is urged that the word "issue" in the statute should be construed to cover the bonds of the Corporation as well as the bonds of the Company. We do not so regard the matter. The statute was not intended to exempt from registration bonds to be issued by companies not in process of reorganization. The value of the bonds offered in exchange depends on the value of the securities back of them. New bonds of a reorganizing company might rightly be presumed to have back of them the same security that the old bonds had, and therefore be of the same value as the old bonds. New bonds of another company offered would presumably have different security back of them. They might therefore be of less value than the bonds for which they were offered in exchange. The exchange of such bonds therefore ought not to be permitted without examination by the commission as to how they are secured, while the exchange of new bonds of the reorganizing Company for its old bonds might properly be admitted without such examination.

In support of the commission's ruling that registration was necessary, it may be stated further that avoidance of registration of the bonds issued by the Corporation for the purpose of taking up the bonds of the Company cannot be justified merely by entries on the books of

the two corporations. The Corporation was issuing new bonds. There can be no question about that. Before those bonds could be sold in Wisconsin, registration of them was necessary under the letter and within the spirit of the law. The naked fact is that the new bonds were new bonds of the Corporation, and according to the law of the state they had to be registered before they could be disposed of in this state. To contend to the contrary is to quibble.

(2) The statute under which the appellants claim the right to registration of the securities is sec. 189.07, Stats. The commission denied the application because in its opinion the provisions of the statute in three particulars were not met. One of these particulars is in respect to unfairness and inequitableness of the plan. The statute provides as to this matter that:

"(1) Upon the filing of an application for registration of securities, the commission shall examine the same and the other papers and documents filed therewith. * * * If * * *

"(b) The plan of financing is not unfair, inequitable, dishonest, or fraudulent. * * *

"(h) The commission * * * shall register such securities; otherwise it shall issue its findings and order denying the application. * * *

In support of the action of the commission in denying the registration, we need and will only consider the finding of the commission respecting the unfairness and inequitableness of the plan. There were outstanding bonds of the Company to the amount of $264,000,000 bearing fixed rates of interest and with successive fixed dates of maturity. The plan proposed that, pursuant to acceptance of opinion (a), fifty million of interest-bearing bonds should be issued, and no more, and the issuance of these might be cut off at any time. The acceptance under option (a) of fifty million of these bonds would cover a hundred million of the bonds of the Company, as those exercising option (a) had to accept new bonds of only one half the face value of the bonds surrendered. This would leave the holders of a hundred and sixty-four million of the Company bonds without the privilege of procuring any of the fifty million fixed interest-bearing bonds. If more than fifty million of these bonds were subscribed for, the fifty million would be allotted according to the whim or favoritism of the officers of the Company, perhaps to officers themselves in preference to others if any officers were among the holders exercising option (a). At any rate, the holders of one hundred sixty-four million of the bonds would have no chance to secure any interest-paying bonds. They were relegated, willy-nilly, to taking one class or the other of the income bonds due in fifty years or so. If perchance no income above interest requirements should be earned, those receiving the income bonds would not only receive no interest, but would be barred from recovering any principal for fifty years, by which time all of them will doubtless be in their graves. This is not treating all bondholders alike. It is not equality, and where equality is lacking so is equity.

By another provision of the plan the surrendered bonds are all to be placed in escrow, and specified persons, as escrow agents, are given

the power at their discretion to resurrect the lifeless Company bonds and substitute them for those received in exchange for them by the Company bondholders. There is no protection against purely arbitrary action of these agents in this respect. Two of the escrow agents are vice-presidents of both the Company and the Corporation. Another is a director of both corporations. The relations of the others to the Company are not disclosed by the record, but the three mentioned are a majority of the agents, and the majority control the acts of the agents. Thus the holders of the new bonds would not know what they had. They would acquire only a "pig in a poke" and would have no means of opening the poke.

While the ostensible purpose of the reorganization was to avoid a receivership, power to force a receivership was merely taken from the hands of the Company bondholders and placed in the hands of the escrow agents who could throw the Company into the hands of a receiver at any time they might arbitrarily choose, perhaps to their own advantage as receivers or otherwise, and to the disadvantage of the bondholders. This suggests a suspicion that the reorganization was in reality conceived in the interest of others than the bondholders. This suspicion is somewhat supported by the fact that while the interest burden of the Company was less than $12,400,000 in 1923, the year next preceding the filing of the application, its net earnings were over $14,800,000, from which it would appear that the imminence of a receivership was more fanciful than real.

The holders of bonds accepted under option (a) could not after ten years exchange these bonds for the income-bearing bonds of the Corporation offered under option (b). In case of failure of the Company and its reorganization or the winding up of its affairs after expiration of that period, fifty millions of the losses of the Company would be borne entirely by the holders of these bonds. Neither the stockholders nor the other bondholders would bear any portion of this loss. And in case the Company should not fail, fifty millions of the Company's debts would be discharged, wholly at the loss of the holders who accepted option (a) and to the benefit of those who accepted the other options and of the Company.

All this is enough in our opinion to warrant the view of the commission that it could not find that the "plan of financing was not unfair and inequitable" and to justify its refusal to register the securities.

The appellants claim that the commission did not make findings as required by the statute. They claim that to justify denial of registration the commission must affirmatively find that the plan of reorganization is either "unlawful, dishonest, fraudulent or otherwise contrary to public policy," or "is unfair, inequitable, dishonest or fraudulent." If such an affirmative finding is necessary, we are of opinion that the commission's decision contains an affirmative finding that is sufficient to support its determination. All the commission was required to find in denying registration in order to satisfy the calls of sec. 189.07, Stats., is that the Company's plan of financing is unfair and inequitable. As has been above stated, the commission filed two deci-

sions. The second was in effect but an affirmance of the first. In the body of the first decision filed it is stated:

"We are of opinion that * * * [certain matters referred to] establish that the Company's plan of financing is unfair and inequitable."

This is a finding of fact, and it constitutes adequate support for the order denying the application before the commission.

By the Court.—The judgment of the circuit court is affirmed.

A motion for a rehearing was denied, with $25 costs, on June 2, 1936.

NOTE

(A) The state Blue Sky laws vary considerably in their scope of application. From the point of view of the investing public, however, the important inquiry for a state is whether its laws provide sufficient protection for its citizens in regard to securities not subject to regulation by the federal acts of 1933 and 1934. Some of the state laws fall far short of this standard. Thus the New York "Martin Act" has been criticized on the ground that it only undertakes to "prevent" fraud after the fraud has occurred. 1931, 8 N.Y.U.L.Q. 465. The same charge applies with equal force to the other "fraud" laws, found in Delaware, Maryland and New Jersey.

(B) The prevalent unfamiliarity of commissions and more especially of prosecuting attorneys of the states with securities acts and their rights and duties thereunder is a serious burden upon the effective administration of the blue sky laws. The frequent changes which take place in administrators result in the removal from office of commissioners who have really learned their business and have become expert in the administration of the law, and the filling of the positions with inexperienced men, to the great injury of the legitimate interests whose business activities are hindered, and also to the detriment of the enforcement of the laws against fraud. Ashby, Economic Effect of Blue Sky Laws, 1926, p. 43.

(C) The selling circular of the 20's was unsatisfactory because it told practically nothing; the present-day prospectus is unsatisfactory because it tells too much. * * * In any case, prospectuses did become cumbersome and technical, so issuers or underwriters devised supplemental literature which subsequently, in effect, took the place of the prospectus and defeated its purpose. Handblotters, booklets, pamphlets, brochures, slides, and movies were created featuring various points contained in the prospectus, and even, in some cases, not in the prospectus. Of course, they were careful to insert a statement in such supplemental literature, that it was not to be construed as the prospectus, to which prospects were referred for complete information. First, only two or three pieces were used, but they kept growing until some issuers had as many as ten or fifteen in use. Some of them contained charts and graphs, or pictures which distorted rather than clarified the true situation. * * * The feeling was created that the prospectus was something that regulatory bodies arbitrarily forced the issuers to prepare and use in their sales. * * * Last October (meaning 1937), the Michigan Corporation and Securities Commission passed a rule forbidding any sales literature to be used in the sale of securities in the State of Michigan except the prospectus. No supplemental literature of any kind may be used unless such supplemental literature in effect only brings up to date material already contained in the prospectus, and it must not contain any other information whatever. * * * Olson, "Regulation of Dealers and Brokers", Proceedings 21st Annual Convention of National Association of Securities Commissioners, 1939, 63, 65, 66.

(D) Consider first the altogether proper desire of issuer and underwriter that the various steps to be taken in the qualification of a security for distribution be so timed that the issue may be offered simultaneously in the various states in which distribution is to be effected. The federal Act, as you know, provides for a "cooling period" of twenty days following the filing of the registration statement,

at the expiration of which, in the absence of the prior filing of an amendment, the statement becomes effective. * * * Prior to the effective date of the registration statement, neither the issuer nor any underwriter or dealer may offer the security for sale or solicit purchases of the same, except that the issuer may, during that period, enter into preliminary negotiations or agreements with the underwriter. In consequence of this requirement, which was designed to prevent the precipitate "forced feeding" of securities to dealers and the public, sub-underwriting groups and selling groups may not be formed prior to the effective date of the statement. In a state having only a "fraud" type of statute, this limitation presents no problem. But in a state which has a "disclosure" or "qualification" type of statute, it is evident that, prior to the effective date, only the issuer itself or the principal underwriters—that is, those distributors who are purchasing directly from or selling directly for the issuer—are in a position to initiate steps for state qualification of the issue. Since in many states qualification must be by a registered dealer doing business in the state in question, difficulties may arise in the initiatng of steps looking toward state qualification with sufficient timeliness to permit clearance of the issue at a date corresponding substantially with the effective date under the federal act. This may not be a serious problem in the case of a large issue having a far-flung network of wholesale distributors; but the difficulties may be genuine where it is desired to effect a reasonably wide distribution of a small but sound issue, having only one or two principal underwriters. One possible solution would be to permit the out-of-state underwriter to file the necessary application and thus to qualify the security, such qualification, however, being conditioned upon the adoption of the application by a local dealer, prior to any sale of the security in the state. An alternative would be to permit qualification by the out-of-state underwriter upon his appointment of the state commissioner as his agent to accept service of process in suits based on the purchase of such security. Either solution would make possible the filing of the state application in ample time to permit adequate examination of the data submitted, and would not deprive any state of its fair portion of sound issues publicly offered upon or immediately after the federal effective date. Throop, "Coordinate Administration of Federal and State Securities Laws," Proceedings 20th Annual Convention of National Association of Securities Commissioners, 1937, 92–94. Consider the accentuation of the problem of simultaneous clearance by the shortening of the 20-day period under the Securities Act within which the registration statement may become effective (*infra*, pp. 806, 807).

(E) Thus, after the preparation of the registration statement required by the federal act it becomes necessary to meet the diverse registration requirements of the various states. This is no small matter. If the issue is a large one a ready market probably cannot be found in a single state. Furthermore, the issuer may desire to secure the benefits from a widespread market covering most of the country. If the issue is an especially desirable security the investors of one state should have an opportunity to acquire their portion of the distribution. These factors will require the registration of the securities under the laws of a number of states. The magnitude of this undertaking is illustrated by the experiences of those who have attempted to follow a registration through the Securities and Exchange Commission and securities commissions of the various states. Their studies show an unorganized, expensive and wasteful procedure. * * * If state registration requirements should not be barriers to the proper flow of investments for industry, especially at a time when the country is trying to step up its production in many lines of national defense, there is reason for seeking correlation of the state provisions with those of the federal Securities Act. To do this it has been suggested that the issuer of interstate issues be permitted to file copies of the federal registration statement or prospectus with the states in satisfaction of their registration requirements. * * * It is the purpose of the federal Securities Act to require that the registration statement shall not contain an untrue statement of a material

fact, or omit to state a material fact required to be stated therein or necessary to keep the statements therein from being misleading. The Securities and Exchange Commission has defined the term "material" to include "such matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." * * * It seems inconceivable that the omission of any fact which is necessary to be stated to prevent the working of a fraud upon the purchaser, or to show the unsoundness of the issuer's business principles, would be permissible under the federal requirements, for surely such facts are "matters as to which an average prudent investor ought reasonably to be informed before purchasing the security", and are necessary to be stated to make other statements not misleading.

The writer by personal letter recently addressed * * * the securities commissions of ten states where by statutes or regulations federal prospectuses or registration statements are accepted as state registration statements or as exhibits thereto. * * * The Commissions of Indiana and Missouri were firm in their beliefs that the federal forms do not contain sufficient information, while the Vermont commission stated simply, "We sometimes find need for different information than is contained in the federal registration prospectus. * * *" The Commissions of Illinois, Massachusetts, Michigan, Ohio, South Carolina, Texas and West Virginia stated that generally the federal registration statements provide ample information. Wright, Correlation of State Blue Sky Laws and The Federal Securities Acts, 1940, 26 Corn.L.Q. 258, 275–278.

C. FEDERAL SECURITIES LEGISLATION SINCE 1933 [1]

1. THE SECURITIES EXCHANGE ACT OF 1934 [2]

NOTE

(A) The broad purpose of the Securities Act of 1933 is to protect the buyer of a newly issued security by requiring a fair disclosure of material facts and by penalizing the failure to furnish them in connection with the sale of the security through the use of the mails or of the instrumentalities of interstate commerce. * * *

The Securities Act itself contains no provisions requiring issuers of securities registered under it to supply investors with current information about these securi-

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1 This section in no way purports to afford a complete study of federal securities legislation since 1933, but is designed only to give the reader a general idea of some of the more important legislation in this field, and to indicate some of the available source material from which a further study of the topic may be initiated. For a general survey of this field of statutory enactment, see: Annual Reports of the Securities and Exchange Commission (U. S. Gov't. Printing Office); Dodd, The Modern Corporation, Private Property and Recent Federal Legislation, 1941, 54 Harv.L.Rev. 917; Hornstein, Legal Controls for Intracorporate Abuse—Present and Future, 1941, 41 Col.L.Rev. 405, esp. 433 et seq.; Note, Distribution of Risk Imposed upon Corporate Officials by Federal Securities Legislation, 1940, 49 Yale L.J. 1423.

2 48 Stat. 881, 1934, 15 U.S.C.A. § 78a.

Hanna, The Securities Exchange Act of 1934, 1934, 23 Calif.L.Rev. 1; Lippman, Constitutionality of The Securities Exchange Act of 1934, 1934, 9 St.John's L.Rev. 2; Lippman, The Securities Exchange Act of 1934 and the Commerce Clause, 1935, 69 U.S.L.Rev. 18; Martin, Constitutionality of The Securities Exchange Act of 1934, 1935, 21 A.B.A.J. 811; Redmond, The Securities Exchange Act of 1934: An Experiment in Administrative Law, 1938, 47 Yale L.J. 622; Rush, Expansion of Federal Supervision of Securities Through the Inquisitional and Census Powers of Congress —A Suggestion, 1938, 36 Mich.L.Rev. 409; Tracy and MacChesney, The Securities Exchange Act of 1934, 1934, 32 Mich.L.Rev. 1025; Legis., The Securities Exchange Act of 1934, 1934, 83 U. of Pa.L.Rev. 255; Note, Delegation of Power Under the Securities Exchange Act of 1934, 1936, 36 Col.L.Rev. 974.

ties. It is not concerned in any way with dealings in securities already issued nor, except to a limited extent, with dealings in securities issued in accordance with its provisions. It is obvious that many factors besides the information available at the time of registration may have a bearing upon the attractiveness of a security to a purchaser. The information provided in the registration statement becomes obsolete in a comparatively brief period. Moreover, whatever the intrinsic merits of a security its desirability for the purpose of investment or speculation is affected by an actual and apparent demand for it. If the purchaser is induced to buy for $200 a security fairly worth $100 the effect upon his solvency may be substantially the same as if he bought for $100 a security worth nothing. While the Securities Exchange Act of 1934 has other purposes, notably the regulation of credit used in security dealings, one of its primary objects is to supplement the protection given the investor by the Securities Act.

The Securities Exchange Act of 1934 supplements the Security Act in two principal ways: (1) It makes available reliable information about the current business conditions of the issuers of what are on the whole the most important securities bought and sold in the United States; (2) It prohibits practices tending to create fictitious values for securities and gives the Securities and Exchange Commission broad powers over the trading in securities. Hanna, The Securities Exchange Act as Supplementary of the Securities Act, 1937, 4 Law and Contemporary Problems 256, 256–257. See also, Hanna, The Securities Exchange Act of 1934, 1934, 23 Calif.L.Rev. 1, 1–10.

(B) The Securities Exchange Act of 1934 has four main purposes: first, the regulation of stock exchanges; second, the prevention of the excessive use of credit for speculation; third, the prevention of manipulation; and fourth, the disclosure of adequate information in regard to securities dealt in on exchanges. The Act also aims at the prevention of unfair methods in the solicitation of proxies in regard to such securities or the use, for personal profit, of confidential information by the directors, officers or principal stockholders of the issuers of such securities.

"Control of securities exchanges is accomplished by making their registration a condition precedent to the lawful transaction of business. The Commission may deny, suspend or revoke any registration, and it likewise has power to compel registered exchanges to make such changes in their rules and practices as the Commission may deem necessary to insure fair dealing on such exchanges. The registration of brokers and dealers engaged in business in over-the-counter markets is likewise required. The Commission, through its power to suspend or expel from membership any member or officer of an exchange and its right to revoke any registration, has a direct and effective power over exchanges, members of exchanges, and over-the-counter brokers and dealers. The disciplinary power of exchanges is made an additional means of enforcement by requiring each registered exchange to incorporate in its rules the provisions of the Act and of the rules and regulations adopted thereunder. Each exchange must also agree to comply with "and to enforce so far as is within its power compliance by its members" with the Act and any rule or regulation made thereunder. * * * Redmond, The Securities Exchange Act of 1934: An Experiment in Administrative Law, 1938, 47 Yale L.J. 622.

(C) The regulatory provisions of the Act, to which all registered exchanges are subject * * * can be roughly divided into three classes: (1) those which undertake to limit speculation; (2) those which undertake to prevent manipulations; and (3) those which place under governmental oversight the finances of corporations whose securities are traded in throughout the country, whether listed on an exchange or not.

(1) Provisions Limiting Speculation

* * * the two stock exchange practices which have been criticized because they tend to encourage speculation are short selling and margin trading. The Act attempts to correct or limit both of these practices.

Short Selling

The Act disposes of the problem of short selling by making it unlawful for any person to use any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange to effect a short sale, except in accordance with such rules and regulations as the Commission may prescribe as appropriate or necessary in the public interest or for the protection of investors. While the Commission may, by its rules, exempt certain classes of transactions from this prohibition it is to be expected that the Commission will respect the opinion of Congress to the effect that short selling should be prohibited and will confine its exemptions to very necessary cases. * * *

Margin Trading

The Act first undertakes to limit *loans by brokers to customers.* It provides that for the purpose of preventing the excessive use of credit in purchasing or carrying securities, the Federal Reserve Board shall, * * * prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security) registered on a national securities exchange. * * *

Another major provision of the Act relates to *loans by banks and others to brokers;* it is aimed to prevent the furnishing by brokers to their customers of excessive amounts of credit for purposes of speculation. No stock exchange member or broker or dealer doing business with a member may borrow money on registered securities, except through a member bank of the Federal Reserve Banking system or a non-member bank which shall have filed with the Board an agreement to comply with all its rules and regulations relative to the use of credit in financing security transactions which are applicable to member banks; nor may a stock exchange member permit his total indebtedness to all other persons, including customers' credit balances, to exceed such percentage of the net capital employed in the business as the Commission may prescribe, not exceeding 2,000 per cent in any case; nor may he hypothecate any securities carried for the account of any customer in a manner to permit the commingling of the customers' securities with those of other customers, without the customers' consent, nor hypothecate securities carried for the accounts of customers so as to permit them to be commingled with securities of any person other than a bona fide customer, or for a sum in excess of the aggregate indebtedness of such customers in respect of such securities; nor may he lend any securities carried for the use of a customer without the written consent of such customer. * * *

(2) Provisions to Prevent Manipulations

The provisions regulating stock exchange practices are contained in Sections 9, 10 and 11 of the Act. They attempt to prevent practically every manipulative device that critics of stock exchange practices have suggested, including wash sales and fictitious trades; pool operations; the dissemination of information that the price of a security is likely to rise or fall by reason of individual or pool activities; the dissemination of false or misleading tips as to market operations; operations for the pegging or stabilizing of stock market prices in contravention of any rules of the Commission; trading in options, such as puts, calls and straddles, and the guaranteeing of such options in contravention of such regulations as the Commission may prescribe, making of short sales and the use of stop-loss orders, except under such regulations as the Commission may prescribe; and the use of any manipulative or deceptive device or contrivance in contravention of any rules ot the Commission. * * * The Act * * * empowers the Commission to prescribe rules to regulate floor trading on the exchanges, and to prevent excessive trading off the floor by exchange members. * * *

(3) Provisions to Insure Publicity Regarding Corporate Affairs

The Act also undertakes to insure adequate publicity as to corporate management and finances. * * * Section 12 provides for the registration of securities traded in on national securities exchanges and requires for all such securities the type of information demanded on new issues under the Securities Act. The registration statement demanded under this section thus fills in the gap left by the Securities Act and the listing requirements of the exchange; it secures similar information regarding securities already outstanding. The provisions relating to unlisted securities provide for a desirable discretion in the Commission and an opportunity for further study on problems that will be difficult to solve in any nice fashion.

The Commission may require every issuer of a registered security to file such information and documents as are necessary to keep reasonably current the material filed pursuant to Section 12. * * *

Section 14(a) makes it unlawful for any person to use the mails or the facilities of interstate commerce or a national securities exchange to solicit proxies without complying with the regulations of the Commission. * * *

Section 14(b) makes it unlawful for any exchange member or any broker or dealer who operates through such a member to give proxies for stock which he carries on account. * * *

Every beneficial owner of more than 10 per cent of any class of registered "equity security", and every director or officer of the issuer thereof, must file a statement of his holdings and report any changes occurring therein at the end of each calendar month. If any such person shall buy a security and shall within six months sell such security at a profit, the profit shall be recoverable by the issuer, irrespective of any original intent to keep the same market position for more than six months. The same rule shall apply to a sale of a security followed within six months by the purchase of the said security at a profit. * * * (The) general purpose (of this section) is to prevent insiders from deriving profit from dealing in securities of their corporation on the basis of information not available to shareholders generally. * * * Tracy and MacChesney, The Securities Exchange Act of 1934, 1934, 32 Mich.L.Rev. 1025, 1039–1056.[3]

[3] See, Hanna, Turlington, Protection of the Public under the Securities Exchange Act, 1935, 21 Va.L.Rev. 251; Neff, Forms for Registration of Securities under the Acts of 1933 and 1934, 1938, 51 Harv.L.Rev. 1354, esp. 1363–1368; Seligman, Problems under the Securities Exchange Act, 1934, 21 Va.L.Rev. 1; Willis, The Banking Act of 1933 in Operation, 1935, 35 Col.L.Rev. 697, 705–711; Legis., Administrative Regulation and Judicial Interpretation under the Securities Exchange Act of 1934, 1938, 86 U. of Pa.L.Rev. 638; Legis., An Explanation of Fundamentals of Stock Market Practice and Procedure in the Light of the Securities Exchange Act of 1934, 1934, 21 Va.L.Rev. 103; Note, Corporations—Securities Exchange Act—Unlisted Trading Privileges, 1938, 37 Mich.L.Rev. 98.

On the regulation of manipulative practices, see: Berle, Stock Market Manipulation, 1938, 38 Col.L.Rev. 393, esp. 398 et seq.; Mathias, Manipulative Practices and the Securities Exchange Act, 1936, 3 U. of Pitt.L.Rev. 7 and 104; Moore and Wiseman, Market Manipulation and the Exchange Act, 1934, 2 U. of Chi.L.Rev. 46; Note, Securities: Stock Market Manipulation At Common Law and under Recent Federal Securities Legislation, 1940, 28 Calif.L.Rev. 378; Note, Market Manipulation and the Securities Exchange Act, 1937, 46 Yale L.J. 624; Note, Expulsion from Stock Exchanges as a Check to Matched Orders and Other Market Manipulation, 1940, 49 Yale L.J. 1469.

On the solicitation of proxies, consents or authorizations, see Sixth Annual Report of the Securities and Exchange Commission, 1941, 113–116; Bernstein and Fischer, The Regulation of the Solicitation of Proxies: Some Reflections On Corporate Democracy, 1940, 7 U. of Chi.L.Rev. 226; Notes, The S.E.C. Proxy Rules and Shareholder Participation in Management, 1940, 53 Harv.L.Rev. 1165, Regulation of Proxy Solicitation by the Securities and Exchange Commission, 1939, 33 Ill.L.Rev. 914.

(D) The Act and many of the rules and regulations so adopted are made effective by criminal penalties. As an additional sanction, the Commission may invoke the aid of the courts to enforce its orders by injunction or mandamus. In order to give force to these sanctions, the Commission has been given broad powers of investigation. It may also make public its findings; * * * The Act also contains a number of civil penalties, intended to implement its provisions. The obligation of directors, officers and principal stockholders to account for profits realized on purchases and sales made within a six months period can be enforced by the issuer or any owner of the securities concerned. Any person who purchases or sells a security at a price which was affected by a violation of the anti-manipulative provisions of the Act may recover damages from any person who wilfully participated in the forbidden act. Any one who purchases or sells a security at a price which was affected by a false or misleading statement in any document filed pursuant to the Act, or any rule or regulation thereunder, may recover damages from whoever made the false statement or caused it to be made. Every contract made in violation of any provision of the Act or of any rule or regulation thereunder, or the performance of which involves such a violation, is declared void and may be set aside at the instance of any person who did not have knowledge of its illegality at the inception of the contract. Redmond, The Securities Exchange Act of 1934: An Experiment in Administrative Law, 1938, 47 Yale L.J. 622, 625–626.[4]

2. THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935[5]

NOTE

(A) The most dynamic legislation of the New Deal affecting corporations may very well be the Public Utility Holding Company Act of 1935. Quite apart from its program of economic planning in which the "death sentence" provisions play so prominent a part, the Act provides a basis for realigning the legal principles of corporate practice. * * * The broad objective of the Act is to protect investors, consumers and the public in general from certain abusive practices in corporate finance and management. * * * The Act proposes to eliminate some of these practices and modify others by a comprehensive program of simplification which is designed to narrow the gap between ownership and management and affects the securities of the individual company, its corporate structure, and the set-up of the holding company system to which it belongs. * * * Meck and Cary, Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935, 1938, 52 Harv.L.Rev. 216, 216–217.

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[4] See, also, Herlands, Criminal Law Aspects of The Securities Exchange Act of 1934, 1934, 21 Va.L.Rev. 139; Yourd, Trading in Securities by Directors, Officers and Stockholders: Section 16 of The Securities Exchange Act, 1939, 38 Mich.L.Rev. 133; Legis., Federal Regulation of Securities: Some Problems of Civil Liability, 1934, 48 Harv.L.Rev. 107; Notes, Publicity and the Security Market: A Case Study, 1940, 7 U. of Chi.L.Rev. 676, Civil Liability for Misstatements in Documents Filed under Securities Act and Securities Exchange Act, 1935, 44 Yale L.J. 456, Investigatory Powers of the Securities and Exchange Commission, 1935, 44 Yale L.J. 819.

[5] 49 Stat. 838, 1935, 15 U.S.C.A. sec. 79 et seq.

II Dewing, Financial Policy of Corporations, 4th Ed., 1941, 1032, esp. 1059 et seq.; Buchanan, The Public Utility Holding Company Problem, 1937, 25 Calif.L.Rev. 517; Compton, Early History of Stock Ownership by Corporations, 1940, 9 Geo.Wash.L. Rev. 125; Meck and Cary, Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935, 1938, 52 Harv.L.Rev. 216; Legis., The Expanding Postal Power 1938, 38 Col.L.Rev. 474, 485–487; Notes, The Public Utility Holding Company Act of 1935, 1935, 30 Ill.L.Rev. 509 and 648, The Constitutionality of the Public Utility Holding Company Act of 1935, 1937, 23 Va.L.Rev. 678; Federal Regulation of Holding Companies: The Public Utility Act of 1935, 1936, 45 Yale L.J. 468.

(B) After a preliminary declaration of policy and a definition of the major terms as used in the context of the Act, Title One provides for the exemption of those holding companies which, because of the nature of their organization or operation cannot be of great importance to interstate commerce or the national public interest. The next section, Section 4 of Title One, is by far the most important single provision of the Act. It makes various interstate activities unlawful for all holding companies unless registered in accordance with Section 5. And it is this registration which brings holding companies within the scope of the remainder of the Act. Sections 6 and 7 impose conditions on the security practice of registered holding companies. It is made unlawful for a registered holding company or its subsidiary to issue, sell, or alter securities unless a declaration has been filed with the Commission. Before such a declaration can become effective, a reasonable time must elapse, during which the Commission may issue an order to show cause why the proposed security action should be taken. After a hearing it may forbid or permit the declaration to become effective; but at no time is commission approval to be given unless detailed requirements prescribed by Congress are complied with. A second set of obligations is directed at the acquisition of any interest in any business by registered holding companies or their subsidiaries. With certain exceptions the approval of the Commission must be obtained before such acquisition can be lawful. And here again Congress names the terms on which such approval shall be given and outlines the information which must be provided in the applications of those companies desiring new properties. The third set of obligations which Congress has decreed shall bind registered holding companies and their subsidiaries is contained in Section 11, which provides, in subsection (a), that the Commission shall examine and determine to what extent (1) holding company systems may be simplified, (2) voting power equitably distributed among security holders, and (3) the properties and business of the system confined to those necessary or appropriate to the operations of an integrated public utility system. Paragraph (1) of subsection (b) makes it the duty of the Commission to require by order, after January 1, 1938, the limitation of holding companies to single integrated systems unless (A) such integrated systems are less economical than diversified ownership, (B) additional systems are regionalized within one power shed, and (C) the combined systems are not so large as to impair the advantages of "localized management, efficient operation, or the effectiveness of regulation." Paragraph (2) of subsection (b) empowers the Commission to require by order, likewise after January 1, 1938, that registered holding companies and their subsidiaries take steps to "ensure that the corporate structure or continued existence of any company in the holding company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders of such holding company system." This paragraph, then, seeks to eliminate the intermediate holding company; but even more specifically this paragraph is directed, in express words, at the elimination of the top or "super" holding companies. The objective of Section 11, the remainder of which is devoted largely to the procedural aspects of the inevitable reorganization in the structure that must accompany compliance with the Act, is removal from corporate structures of those units which serve no desirable social or economic function. Having thus made provision for a simpler and more integrated system, Congress in the next section of the Act makes some stipulations as to future fiscal policy. "Upstream loans" to registered holding companies are henceforth absolutely banned and all loans and credit extensions made by registered holding companies to the members of their systems are subjected to Commission rules. Excessive dividend payments and other objectionable fiscal practices are likewise prohibited. Also of interest are the clauses forbidding political contributions by members of a registered holding company system, and the declaration making it unlawful to lobby before certain government bodies unless registration and information statements are recorded with the Commission by such lobbyists. A fifth group of

provisions centers about service, sales and construction contracts, the power to participate in which is denied by Section 13 to registered holding companies. Such contracts are restricted to mutual service companies or subsidiaries of registered holding companies, or affiliates, or other persons who operate in accordance with rules and regulations prescribed by the Commission. Exceptional circumstances however will, as usual, justify exemptions. The final set of obligations imposed on registered holding companies provides for the submission of accounts, reports, and general information on holding company affairs. The bulk of the remaining sections merely specify the procedure to be followed by the Commission and the courts in the enforcement of the Act, and set forth both the civil and criminal liabilities incurred by any infraction of its terms. Note, Federal Regulation of Holding Companies: The Public Utility Act of 1935, 1936, 45 Yale L.J. 468, 482–484.[6]

3. THE TRUST INDENTURE ACT OF 1939[7]

(See Part IV, Funded Debt, pp. 861–921, passim, *infra.*)

4. THE INVESTMENT COMPANY ACT OF 1940[8]

NOTES

(A) The Investment Company Act of 1940 is the newest comprehensive piece of national legislation drawn in the "interest of investors" and entrusted for administration to the Securities and Exchange Commission. That its passage was achieved with the complete cooperation of the industry adds significance to the Act, whether it be considered purely as a much needed regulatory measure in that particular industry, or whether it be considered as suggesting the temper of any further federal legislation supervising corporations. Note, The Investment Company Act of 1940, 1941, 50 Yale L.J. 440.

(B) * * * the Federal Investment Company Act of 1940 * * * declares formally that both the national public interest and the interest of investors are adversely affected by certain specified occurrences, such as the issuance by investment companies of securities which fail to protect the preferences and privileges of their holders, or the operation of such corporations in the interest of the management or affiliated persons rather than in the interest of all classes of the corporation's security holders. Hornstein, Legal Controls for Intracorporate Abuse—Present and Future, 1941, 41 Col.L.Rev. 405, 430–431. See, also, at 434–435.

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[6] See, also, Legis., The Servicing Function of Public Utility Companies, 1936, 49 Harv.L.Rev. 957, esp. 989 et seq.; Notes, Procedural Aspects of the Litigation under the Public Utility Holding Company Act, 1937, 50 Harv.L.Rev. 655; The Rights of Cumulative Preferred Stockholders under the Public Utility Holding Company Act, 1939, 52 Harv.L.Rev. 1331; Constitutional Law—Validity of Registration Provisions of Public Utility Holding Company Act of 1935, 1938, 36 Mich.L.Rev. 1324; Public Utility Holding Company Act—Corporate Simplification and Geographic Integration Under Section 11, 1938, 36 Mich.L.Rev. 1360; Reorganizations Under Section 11(g) of The Public Utility Holding Company Act, 1939, 49 Yale L.J. 65; Federal Control over Corporate Distributions to Stockholders under The Public Utility Holding Company Act, 1940, 49 Yale L.J. 492; Geographic Integration under the Public Utility Holding Company Act, 1941, 50 Yale L.J. 1045; Distribution of Voting Power under the Public Utility Holding Company Act, 1941, 50 Yale L.J. 1228.

[7] 53 Stat. 1149, 1939, 15 U.S.C.A. § 77 aaa et seq.

[8] 54 Stat. 789, 1940, 15 U.S.C.A. § 80a—1 et seq. Jaretzki, The Investment Company Act of 1940, 1941, 26 Wash.U.L.Q. 303; Thomas, The Investment Company Act of 1940, 1941, 9 Geo.Wash.L.Rev. 918; Tolins, The Investment Company Act of 1940, 1940, 26 Corn.L.Q. 77; Notes, The Investment Company Act of 1940, 1941, 41 Col.L.Rev. 269; Regulation of Investment Companies, 1940, 88 U. of Pa.L.Rev. 584; The Regulation of Management Investment Trusts for the Protection of Investors, 1937, 46 Yale L.J. 1211; The Investment Company Act of 1940, 1941, 50 Yale L.J. 440.

(C) The regulatory mechanism established by the Act employs the jurisdictional basis of other recent securities acts and follows the now familiar pattern of requiring that all but certain exempt companies register with the SEC or else be denied use both of the mails and of the instrumentalities of interstate commerce. While the publicity attendant to registration is expected to prove a corrective to many of the evils in the industry, experience has shown that in many cases publicity alone is insufficient. Consequently the Act goes further and forbids certain organizational and operational practices, fortifying these prohibitions with both injunctive relief and criminal penalties. * * *

The difficult and important task of framing a workable definition of an investment company was solved by including in general language all issuers actually, professedly, or prospectively engaged "primarily in the business of investing, reinvesting, or trading in securities," and by prescribing a statistical formula to amplify this general definition and to determine questionable cases. * * * specific provisions are made in the Act to exclude any securities companies which might fall within the letter of the definition but without the spirit of the regulation. * * * The SEC is in general given power to see that the conditions annexed to the exemptions are met; and a final bit of "rubber" in the definition gives the SEC power to exempt any person, security, or transaction from any or all provisions of the Act provided such exemption is in accord with the policy of legislation and consonant with the protection of investors. * * *

The Act divides investment companies into "face-amount companies", "unit investment trusts," and "management companies"—a classification which conforms closely to the categories existing in the industry today. * * *

Unlike the Public Utility Holding Company Act, the present measure does not effect radical changes in the structure of existing companies. However, in the future no company may make public offering of its securities unless it has or originally had a net worth of at least $100,000 * * * or has firm commitments from not more than twenty-five responsible persons to purchase securities which will bring the net worth to this figure. * * *

Structures involving cross and circular ownerships are handled by forbidding registered companies to purchase any securities making for such a situation and by requiring any such ownership extant in the industry at the present time to be eliminated within five years from the date of the Act. * * *

Strict limitations are placed upon the kind and amount of senior securities which may be issued in the future either by existing companies or by those subsequently formed—limitations made necessary by the malpractices which have previously centered about such securities. * * *

Virtually all of the host of sharp practices which formerly attended the issuance of investment company securities are sought to be curbed by the present Act. Under its terms no stocks can be issued for services or for property other than cash and securities, except as a dividend or distribution to its security holders or in connection with reorganizations; thus the familiar practice of exchanging choice securities for "promotional expenses" is eliminated. The equally familiar practice of "diluting" securities by selling them below their asset value is likewise curbed; and another avenue of dilution is closed by limiting the issuance of stock warrants or rights to subscribe to short term rights. Contracts with principal underwriters are subject to approval by an independent board of directors or by the holders of outstanding securities, and are limited as to duration and assignability; * * *

Dividend payments are subject both to the asset coverage requirements * * * and to the additional requirement that such payments be made only from net income, as determined by good accounting practice, or if not so made, that they be accompanied by a written statement which adequately discloses the source of such payments. * * *

Under the Act every share of stock hereafter issued by management or face-amount companies must be a voting stock, possessing equal voting rights with every other outstanding voting stock. An exception to this requirement is provided in the case of management companies already organized as common law trusts. * * *

The Act requires that various fundamental matters be submitted to the vote of stockholders, chief among these being the approval of management contracts, the effecting of vital changes in the policy or purpose of the companies, and the election of directors. * * *

Finally, further provisions safeguarding voting rights prohibit public offerings of voting trust certificates and confer upon the SEC the power to establish rules and regulations governing the soliciting of proxies. * * *

The present legislation plugs the loopholes whereby investment companies have escaped registration under the Acts of 1933 and 1934, and subjects both outstanding and prospective security issues to the requirements of those Acts. Moreover, the registration required by the present Act insures still additional disclosures, for all registrants must choose the classification and sub-classifications within which they propose to operate and must define their policy with regard to activities such as those discussed above as well as several others. Changes and deviations from the policies established by the registration statement may be made only when authorized by the vote of a majority of the outstanding voting securities. * * * Teeth are placed in these provisions by giving the SEC power to suspend registrations if a company fails to provide the information required or makes material misstatements therein, and by granting the SEC the further powers of prohibiting the use of misleading names and of supervising the sales literature employed by investment companies.

Likewise, adequate information relative to current activities is assured investors and the SEC by requiring the periodic submission to both of detailed reports covering the financial status of the company, the securities owned, recent security turnover, and the remuneration of company officials. * * *

Recognizing the limitations inherent in publicity as a corrective or preventive device, the present Act contains specific prohibitions against self-dealing and greatly curtails the potentialities accompanying conflicts of interest. * * * the Act provides for an independent majority on the board of directors, the function of which majority is to check any untoward activities on the part of those minority directors who are also serving the company in other capacities. * * *

A novel attempt to purge the industry of undesirable persons is found in a provision which closes the doors of the industry to persons who, within ten years, have been convicted of any felony or misdemeanour arising out of securities transactions or who are permanently or temporarily enjoined from engaging in such transactions. * * * Finally, these protections are buttressed by sweeping aside the exculpatory clauses which formerly shielded questionable practices, by subjecting the settlement of "strike suits" and other civil actions to the scrutiny of the SEC, and by authorizing the SEC to require the bonding of any officers or employees who have access to funds or securities of investment companies. * * * Note, The Investment Company Act of 1940, 1941, 41 Col.L.Rev. 269, 275–291. The Act also contains provisions relative to the activities of investment companies. Permissible investments, the safeguarding of assets, the redemption and resale of company securities and the exchanges of securities are all dealt with in regulatory sections of the statute. See, Investment Company Act of 1940, §§ 11, 12, 17, 22, 23, 26 and 28; Note, The Investment Company Act of 1940, 1941, 41 Col.L.Rev. 269, 291–294.

5. THE INVESTMENT ADVISERS ACT OF 1940 [9]

§ 201: Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission * * * it is hereby found that investment advisers are of national concern, in that, among other things—

(1) their advice, counsel, publications, writings, analyses, and reports are furnished and distributed, and their contracts, subscription agreements, and other arrangements with clients are negotiated and performed by the use of the mails and means and instrumentalities of interstate commerce;

(2) their advice, counsel, publications, writings, analyses, and reports customarily relate to the purchase and sale of securities traded on national securities exchanges and in interstate over-the-counter markets, securities issued by companies engaged in business in interstate commerce, and securities issued by national banks and member banks of the Federal Reserve System; and

(3) the foregoing transactions occur in such volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking system and the national economy.

§ 202(a) (11) "Investment adviser" means any person who, for compensation engages in the business of advising others, * * * as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. * * *

The Act exempts from its provisions banks, brokers, lawyers and the like, whose financial advice is merely incidental to the practice of their profession or business.

No investment adviser may use the mails or any instrumentality of interstate commerce in connection with his business as adviser unless he is properly registered with the Securities and Exchange Commission (§ 203).

In addition to its registration requirements, the Act provides for the filing of annual and special reports with the Commission (§ 204) and for the publicity of registration statements and annual reports (§ 210). Investment advisory contracts are regulated (§ 205), and all contracts made in violation of the Act are expressly declared void (§ 215).

Registered investment advisers are prohibited from employing any fraudulent practices or devices (§ 206); from making any material misstatements or omissions in any registration application or filed report (§ 207); and from making any unlawful representations (§ 208).

Under the Act, the Commission is empowered to make investigations (§ 209), to conduct public hearings (§ 212), and to make rules and regulations incidental to the carrying out of the provisions of the statute (§ 211).

The Commission is also given power to bring injunctive proceedings in United States District Courts to enforce the provisions of the Act, and, in addition, to transmit evidence of violations to the Attorney-General, who may in his discretion, institute appropriate criminal proceedings (§ 209).

In addition to voiding contracts made in violation of the Act, the statute provides (§ 217) that any person who wilfully violates any of its provisions may be subject to a maximum $10,000 fine and/or be imprisoned for not more than two years.

[9] 54 Stat. 847, 1940, 15 U.S.C.A. sec. 80b—1, et seq.

PART IV

FUNDED DEBT

NEW YORK STOCK CORPORATION LAW

§ 16. *Power to borrow money and mortgage property.* 1. Every stock corporation other than a moneyed corporation shall have the power to borrow money and contract debts, when necessary for the transaction of its business, or for the exercise of its corporate rights, privileges or franchises, or for any other lawful purpose of its incorporation; and it may issue and dispose of its obligations for any amount so borrowed, and may mortgage its property and franchises to secure the payment of such obligations, or of any debt contracted for such purposes. The consent to the execution of such mortgage, except a purchase-money mortgage, by the holders of not less than two-thirds of the total number of shares outstanding entitled to vote thereon, given either in writing, or by vote at a meeting of the stockholders called for that purpose in the manner prescribed by section forty-five, shall be required. * * * When authorized by like consent, the directors, under such regulations as they may adopt, may confer on the holder of any debt or obligation, secured or unsecured, the right to convert the principal thereof within such period and upon such terms and conditions as may be fixed by the resolution of the directors conferring the right of conversion, into stock of the corporation.

NOTE

A corporation cannot have an economic life unless it have adequate capital to finance the activities for the performance of which it was formed. This capital may be acquired either through subscription to equity securities (such as capital stock) or through the exercise of the corporation's borrowing power. If the latter alternative be adopted, the corporation has several avenues open to it, but perhaps the best for the needs of the larger corporate entity is the borrowing of comparatively great sums of money against its corporate obligations which are of such a character that they may be held by investors. The predominant corporate obligation in use in the United States has been the corporate bond secured by an indenture of mortgage upon the property of the obligor. * * *

The thought that property might be security for a loan of money has existed for many centuries, but the American form of corporate bond secured by a deed of trust modeled after the general form of mortgage on real estate is of comparatively recent origin. Apparently the first corporate mortgage was made by the Morris Canal and Banking Company, in 1830, to one Willink, as Trustee, to secure a loan of $750,000. * * * It is of course more than well known that since that time financing through the issue of secured corporate bonds has been undertaken by practically all of the leading corporations, whether railroad, public utility or industrial.

The mortgages securing such corporate bonds are almost invariably in the form of a deed of trust containing a power of sale. The use of trustees to take and hold the mortgaged property as security for the benefit of the bondholders affords a device for unified action which otherwise would be impossible, especially since the holders of the bonds are numerous and of changing identity. This relative facility of action between the mortgagor and the trustee is of particular advantage in matters

entire issue may be paid off; and, under the same trust indenture, the entire amount may be reissued; or, part may be paid off and an equal amount reissued at once. Thus the security stands as permanent security for a maximum obligation which need never be reduced, although individual bonds may be paid off and new bonds issued to new holders in their place.

(b) Another type secures not merely a stated maximum amount of bonds, but also permits that amount to be increased, usually in proportion to increased value of, or additions to, the property of the issuing corporation. Public utility bonds are apt to be issued under this type of indenture.

In a very loose type the mortgage or trust indenture mortgage or indenture may secure an absolutely unlimited principal amount; permitting the corporation to issue bonds indefinitely. This, of course, is an unsafe type. Or, and more usually, the mortgage or indenture permits the corporation to issue bonds up to a stated percentage of the value of the corporate property then existing or thereafter acquired. A machinery is set up for having the cost or fair value of such additional property ascertained and proved to the satisfaction of the trustee. It will be seen that this type of mortgage literally runs forever; and the bond issue is an indefinite amount, though in theory a relation is preserved between the amount of the outstanding bonds and the value of the property. Today, the idea of corporations having steady requirements for new capital (as is the case with public utilities) is to have an open end mortgage or trust indenture with some bank as trustee, available as security for any new bond issues which it may wish to put out; thereby avoiding the expense and difficulty and loss of time in discharging old bond issues and getting up new mortgages, etc.

Certain of such mortgages or trust indentures, permit additional bonds to be issued against additions to property account, but require deductions because of retirements (and sometimes maintenance or replacement requirements as well) from the additional property on which the new bond issue is based. This type of mortgage or trust indenture is called a "net additions mortgage", and is commonly used by public utilities. Mortgages or trust indentures which do not require such deductions to be made from additional property are called "gross additions mortgages", and are commonly used by railroad corporations.

For a general discussion of the various types of bonds see:

A. S. Dewing, The Financial Policy of Corporations, Ronald, Revised 4th Ed. 1941, Vol. I, c. 8-11.

R. H. Montgomery, Financial Handbook (Ronald 1925) pp. 568–81.

For a discussion of the various types of corporate trust indentures see:

F. L. Stetson, Preparation of Corporate Bonds, Mortgages, Collateral Trusts and Indentures—Some Legal Phases of Corporate Financing, Reorganization and Regulation (1922).

NOTE

The courts have determined that the fact that an instrument is called a "bond" is not conclusive as to its character. * * * The distinguishing feature of a bond is that it is an obligation to pay a fixed sum of money with stated interest. The distinguishing feature of stock is that it confers upon its holder a part ownership of the assets of the corporation and gives him a right to participate in the management of the corporation and to share in the surplus profits and on dissolution to share in the assets which remain after the debts are paid. In re Fechheimer Fishel Co., 212 F. 357, 360, C.C.A.N.Y.1914; cert. den., 234 U.S. 760, 1914. See, also, Dewing, The Financial Policy of Corporations, 4th Ed., 1941, Vol. I, c. 8, 9, 11; Montgomery Financial Handbook, 2d Ed., 1933, § 10; Stetson, op. cit.

THE TRUST INDENTURE ACT OF 1939

The Trust Indenture Act of 1939 requires that bonds, notes, debentures, and similar securities publicly offered for sale, sold, or delivered after sale through the mails or in interstate commerce, except as specifically exempted by the Act, be issued under an indenture which meets the requirements of the Act and has been duly qualified with the Commission. The standards of the Act outlaw many provisions previously incorporated in indentures to exculpate the trustee. The Act is designed to insure that he will act on behalf of the bond or debenture owners and to insure his complete independence of the issuer and the underwriters. The provisions of the Securities Act of 1933 and the Trust Indenture Act of 1939 are so integrated that registration pursuant to the Securities Act of 1933 of such securities to be issued under a trust indenture shall not be permitted to become effective unless the indenture conforms to the specific statutory rquirements expressed in the Trust Indenture Act of 1939. The indenture is automatically 'qualified' when registration becomes effective as to the securities themselves.

The Trust Indenture Act of 1939, approved August 3, 1939, is the second of the two statutes which resulted from the Commission's study and investigation of protective and reorganization committees. It was designed to correct certain defects which had existed in trust indentures and to provide means whereby the rights and interests of security holders can be more effectively safeguarded. In order to accomplish this objective, the Act provides that issues of bonds, notes, debentures and similar debt securities exceeding one million dollars in principal amount, except certain classes which are specifically exempted, may not be offered for sale to the public unless they are issued under a trust indenture which conforms to specific statutory standards. The Commission has no powers with respect to the enforcement of the provisions of the indenture. Its only functions under the Act are to see that the trustee is eligible and qualified as provided in the Act and that the provisions of each indenture filed for qualification conform to the prescribed statutory standards. The Act is based on the theory that, if the terms of the trust indenture provide adequate protection for investors, it is appropriate to leave the enforcement of such terms to the bondholders without the continuing supervision of a governmental agency. * * *

An indenture, to be qualified under the Act, must incorporate certain specific provisions, including those governing the eligibility and qualification of the trustee, and must provide for periodic reports by both the obligor and the trustee to the security holders with respect to compliance by the obligor with conditions and covenants contained in the indenture and the trustee's continued eligibility. The Commission is required to issue an order refusing to permit qualification of an indenture if the indenture does not conform to the statutory requirements or if the trustee has any conflicting interests as defined in the statute.

The indenture, in order to facilitate the cooperation of security holders in the protection of their interests, must provide that the trustee will maintain a reasonably current list of their names and addresses and either make the list available to such of their number as desire to communicate with the others or mail communications, to those whose names appear on the list, when they are submitted by security holders with a remittance to cover the cost. If the trustee is of the opinion that the mailing of the material to the bondholders would be detrimental to their interests or in violation of applicable law, it may file with the Commission a copy of the material with a written statement specifying the basis for its opinion. After opportunity for hearing upon the objections specified in the trustee's statement, the Commission is authorized to enter an order either sustaining or refusing to sustain the objections made by the trustee.

One of the principal objectives of the Act is to insure that the holders of indenture securities will have the services of an effective and independent trustee.

Standards relating to the eligibility and qualification of trustees are established in the Act. Provision must be made for a corporate trustee with a minimum capital and surplus of not less than $150,000 and with certain specified powers and duties to insure the more adequate protection of investors.

If a trustee has or acquires an interest in conflict with that of the security holders under the indenture, it must either eliminate the conflict of interest or give up the trusteeship. The conditions under which a trustee shall be considered to have such a conflicting interest are set forth in detail in the Act. In general, the trustee must not be affiliated with either the obligor or an underwriter of the securities. Obviously, the trustee should not be permitted to be too closely affiliated with the obligor because the creditor interests represented by the trustee will clearly be adverse to the interests of the obligor and its stockholders in case there is a default or the threat of one. To a lesser extent there may be a conflict of interest between the two all during the life of the indenture securities with regard to such matters as substitution of collateral, disclosure of financial condition, declaration and payment of dividends, and wasting or diversion of assets.

Experience has proved that there is also grave danger in permitting the trustee to be affiliated with an underwriter of the indenture securities. This is true particularly in default situations where underwriters may consider it to their interest to conceal the default long enough to secure control of reorganization committees. The Trust Indenture Act is designed to eliminate the use of friendly or complacent trustees who fail to warn security holders and take no steps contrary to the wishes of the obligor or underwriter.

In case of default by the obligor (as this term is defined in the indenture), the duties and responsibilities assumed by the trustee are increased. A qualified indenture may provide that, prior to default, the trustee shall not be liable except for the performance of duties specifically set out in the indenture but in case of default it must require the trustee to exercise such of the rights and powers vested in it by the indenture and to use the same degree of care and skill in their exercise as a prudent man would exercise or use under the circumstances in the conduct of his own affairs. These provisions are designed to bring all indenture trustees up to the high level of diligence and fidelity which has traditionally been associated with the more conscientious trustees. Tenth Annual Report of the Securities and Exchange Commission: A Ten Year Survey, 1934-1944, pp. 115-116.

ENOCH v. BRANDON

Court of Appeals of New York, 1928. 249 N.Y. 263, 164 N.E. 45.

Appeal from a judgment, entered May 10, 1928, upon an order of the Appellate Division of the Supreme Court in the fourth judicial department, reversing a judgment in favor of defendants entered upon a dismissal of the complaint by the court at a Trial Term without a jury and directing judgment in favor of plaintiff.

ANDREWS, J. The question before us is whether certain bonds are negotiable instruments. If so, the purchaser in due course from a thief may retain them.

The Manitoba Power Company issued a series of bonds. It promised to pay the bearer of each on November 1, 1941, a certain sum at a certain place, with interest. They are said to be "all equally secured by and entitled to the benefits and subject to the provisions" of a trust mortgage. They may be redeemed at 105 per cent and interest at certain dates. The obligor must create a sinking fund to

provide for their purchase or redemption and the principal may become due in advance of maturity in case of default under the mortgage; all as provided in the mortgage "to which reference is hereby made for a description of the property mortgaged and pledged, the nature and extent of the security, the rights of the holders of the bonds with respect thereto, the manner in which notice may be given to such holders, and the terms and conditions upon which said bonds are issued and secured." The bonds may be registered in the usual way and except where registered "they are to be treated as negotiable and all persons are invited by the Company to act accordingly."

At times this last provision might aid in the construction of doubtful clauses contained in the instrument before the court. It at least shows that the parties intended to omit anything that might impair negotiability. But no such statement will make negotiable a bond not in the form provided by our statute. Whether the result was or was not fortunate it is too late to argue that the Legislature did not refer to bonds in its all-inclusive definitions of negotiable paper. True, to become negotiable an instrument need not follow any precise language. (Negotiable Instruments Law [Cons.Laws, ch. 38], sec. 29.) But it "must conform" to the definition specified in section 20. In the face of a command so explicit we must adhere to the design of the Legislature (American Nat. Bank v. Sommerville, 191 Cal. 364, 216 P. 376.) At times contract rights may be enforced or some theory of estoppel adopted, but no intention, no agreement, may make negotiable an instrument which the statute declares to be non-negotiable.

We turn, therefore, to the more serious question. The statute deals with the form of the instrument—with what a mere inspection of its face should disclose. It must contain an unconditional promise to pay a fixed sum, on demand, or at a fixed or determinable future time, to order or to bearer. Only if it fulfills these requirements is it negotiable. If it does, no collateral agreement affects its character.

If in the bond or note anything appears requiring reference to another document to determine whether in face the unconditional promise to pay a fixed sum at a future date is modified or subject to some contingency, then the promise is no longer unconditional. What that document may provide is immaterial. Reference to the paper itself said to be negotiable determines its character. Old Colony Trust Company v. Stumpel, 247 N.Y. 538, 161 N.E. 173.

Provisions other than those required by section 20 may be contained in a bond or note without impairing its negotiability. There may be included, among other things, a statement of the transaction giving rise to the instrument (sec. 22) or a statement as to collateral security. (Sec. 24.) And it may refer to a trust mortgage, or to an agreement as to the collateral which fixes the remedies of the parties with respect thereto. (Chelsea Bank v. Warner, 202 App.Div. 499, 195 N.Y.S. 419.)

The rule itself is not a difficult one. The trouble, as often happens, lies in its application to particular facts. There is no infallible test as to whether there is a modification of the promise. Because of

differences in the words used, or in the arrangement of paragraphs, sentences or clauses, each instrument must be interpreted by itself. Only then may we solve the question as to its character.

Three cases in this State will serve as an illustration. In McClelland v. Norfolk Southern R. R. Co. (110 N.Y. 469, 18 N.E. 237) the bond itself showed that the promise to pay was a conditional one. It was to become payable upon the terms and with the effect mentioned in the trust mortgage. In Hibbs v. Brown (190 N.Y. 167, 82 N.E. 1108) the precise form of the bond involved does not appear in the printed case and exceptions. It did, however, contain a clause referring "to the deed of trust for a statement of the rights of the bondholders and of the securities and property securing the payment of the bonds," and we said that this clause had only to do with procedure under the trust indenture. In Old Colony Trust Company v. Stumpel (247 N.Y. 538, 161 N.E. 173) the note stated that it was "subject to the terms" of a conditional sales agreement. Here by no possibility did the clause relate to security. Necessarily it had to do with the terms of payment.

Do then the references in these particular bonds to the trust mortgage modify the promise to pay; do they subject it to some possible condition or contingency described elsewhere, or do they merely determine the rights and remedies of the holder under the mortgage? We must consider the instrument as a whole, not wresting any one phrase from its context and concentrating our attention upon it alone. Further, where the meaning is doubtful, we must adopt the construction most favorable to the bondholder.

The bonds are part of an issue of $7,500,000, "all equally secured by and entitled to the benefits and subject to the provisions" of the trust mortgage. Then, speaking of possible redemption, of acceleration of payment, of a sinking fund and of notice, it continues "all as provided" in the trust mortgage "to which reference is hereby made for a description of the property mortgaged and pledged, the nature and extent of the security, the rights of the holders of the bonds with respect thereto, the manner in which notice may be given to such holders, and the terms and conditions under which said bonds are issued and secured."

We hold that here there is no modification of the promise to pay, made in explicit terms. The provisions all have to do with the trust mortgage. They refer to the rights conferred by it upon the bondholders and limit and explain those rights. They are so linked together as to indicate that the obligor was speaking solely of the security. A purchaser scanning the bonds would have the same thought. It would never occur to him that when November 1, 1941, arrived, because of something contained in the mortgage he might be unable to collect the amount due him. He would interpret the statement that the bonds were secured by and entitled to the benefits and subject to the provisions of the mortgage, as meaning that a foreclosure or other relief might be had thereunder only subject to its provisions. He would see that reference to it is also made to determine the terms and conditions under which the bonds are issued and secured. Again it would mean to him as it means to us, that

only by turning to the mortgage might he discover the precise nature of the lien he is to obtain. He would see that the bonds were to be issued not only upon the general credit of the corporation, but upon the faith of some collateral mortgage. To it he must go if further knowledge as to this security is desired.

Some minor matters are also to be considered. There is the possibility of the acceleration of the date when the bonds are due if there is default under the mortgage. Such a possibility does not make them non-negotiable. (Higgins v. Hocking Valley Ry. Co., 188 App.Div. 684, 177 N.Y.S. 444; Chicago Railway Equipment Company v. Merchants' Bank, 136 U.S. 268, 284, 10 S.Ct. 999, 1003; Mackintosh v. Gibbs, 81 N.J.L. 477; Schmidt v. Pegg, 172 Mich. 159, 137 N.W. 524; White v. Hatcher, 135 Tenn. 609, 188 S.W. 61). A note is payable at a determinable future time if payable on or before a fixed date. (Sec. 23.) And in one case acceleration of payment in case of default is expressly recognized. (Sec. 21.) The same thing is true of the privilege given the obligor to redeem at 105 per cent before the bonds became due. That does not limit its absolute promise to pay on November 1, 1941. The bonds are payable to bearer or if registered to the registered holder. This does not affect their negotiability. (Dickerman v. Northern Trust Company, 176 U.S. 181, 20 S.Ct. 311.) Nor does the provision requiring the obligor to create a sinking fund.

The Judgment of the Appellate Division should be reversed and that of the Trial Term affirmed, with costs in this court and in the Appellate Division.

CARDOZO, Ch. J., CRANE, LEHMAN, KELLOGG and O'BRIEN, JJ., concur; POUND, J., dissents.

Judgment accordingly.

A. THE TRUSTEE

NOTE

The trustee as an intermediary for security purposes between corporate debtors and their creditors is a development of the "blanket" corporate mortgage. Originally loans were of such character that security could be given by mortgage made directly to the lender-mortgagee. The growth and development of modern corporate activity, however, entailed such large scale borrowing that single mortgagee creditors were no longer equal to the task.[1] To meet the problem, corporations began to finance their operations by is-

[1] Welch v. Northern Bank & Trust Co., 100 Wash. 349, 356, 170 P. 1029, 1032 (1918): 'The sale of corporate securities through the mediumship of trust companies is a method of reaching the individual investor. Such securities are generally issued in large amounts, and because of the impracticability of disposing of them, or obtaining loans in single payments, the business world has resorted to the method of mortgaging properties and securities to a trustee company to be disposed of piecemeal to investors who are able to make small investments.

It is interesting to note that Reconstruction Finance Corporation for the past several years has again been assisting 'large-scale financing' by direct mortgage, reserving the trustee device for those cases where a substantial amount of 'local financing' was to be secured on a substantial parity with its own.

suing their indebtedness to an underwriting concern for apportionment among a larger and more diverse group of creditors or bondholders. Recourse was then had to the device of a trustee as mortgagee so that the impossible task of securing each credit by a separate mortgage could be dispensed with. McClelland and Fisher, The Law of Corporate Mortgage Bond Issues (1937), pp. 780-781.

TRUST INDENTURE ACT OF 1939, 15 U.S.C.A. § *77 jjj.*

Eligibility and Disqualification of Trustee—Persons Eligible for Appointment as Trustee

(a) (1) The indenture to be qualified shall require that there shall at all times be one or more trustees thereunder, at least one of whom shall at all times be a corporation organized and doing business under the laws of the United States or of any State or Territory or of the District of Columbia (referred to in this subchapter as the institutional trustee), which (A) is authorized under such laws to exercise corporate trust powers, and (B) is subject to supervision or examination by Federal, State, Territorial, or District of Columbia authority.

(2) The indenture to be qualified shall require that such institutional trustee shall have at all times a combined capital and surplus of a specified minimum amount, which shall not be less than $150,000. If such institutional trustee publishes reports of condition at least annually, pursuant to law or to the requirements of said supervising or examining authority, the indenture may provide that, for the purposes of this paragraph, the combined capital and surplus of such trustee shall be deemed to be its combined capital and surplus as set forth in its most recent report of condition so published.

(3) If the indenture to be qualified requires or permits the appointment of one or more co-trustees in addition to such institutional trustee, such indenture shall provide that the rights, powers, duties, and obligations conferred or imposed upon the trustees or any of them shall be conferred or imposed upon and exercised or performed by such institutional trustee, or such institutional trustee and such co-trustees jointly, except to the extent that under any law of any jurisdiction in which any particular act or acts are to be performed, such institutional trustee shall be incompetent or unqualified to perform such act or acts, in which event such rights, powers, duties, and obligations shall be exercised and performed by such co-trustees.

TSCHETINIAN v. CITY TRUST COMPANY OF NEW YORK

Court of Appeals of New York, 1906. 186 N.Y. 432, 79 N.E. 401.

Appeal from a judgment, entered December 21, 1905, upon an order of the Appellate Division of the Supreme Court in the second judicial department, which affirmed a judgment of Special Term sustaining a demurrer to the complaint.

The nature of the action and the facts, so far as material, are stated in the opinion.

HISCOCK, J. This action, as evidenced by the complaint, sought to hold defendant responsible for the value of certain bonds purchased by plaintiff which became valueless. It was based upon a certificate made by defendant, as mortgage trustee under a corporation mortgage, upon an issue of $100,000 of bonds which included those purchased by the plaintiff. This certificate was indorsed upon each bond, and read as follows: "This bond is one of a series of bonds mentioned and described in the mortgage referred to." The bonds so certified were each indorsed by the mortgagor as a "First Mortgage Bond," whereas in fact they were not such, being subsequently cut off by the foreclosure of a first mortgage.

Plaintiff claims that defendant's certificate was broad enough to be a guaranty that they were first mortgage bonds. The Appellate Division has decided that the facts stated in the complaint do not sustain this view, and we concur in the conclusion thus reached by that court.

In addition to the facts already stated by way of introduction, reference may be made to a few others. The United States Carbonate Company executed to defendant, as trustee, a mortgage upon certain real estate and other property to secure the issue of bonds above mentioned. These bonds were issued in the denomination of $500 each. The prior mortgage amounted to $15,000, and, when subsequently foreclosed, absorbed practically all of the proceeds of the property covered by the mortgage securing the bonds in question. Plaintiff had purchased twenty of these bonds, which were thus rendered valueless.

His counsel advances various reasons for sustaining the sufficiency of his complaint against the attack of the demurrer which are not at all based upon the allegations of the complaint, and, therefore, need not be considered.

The complaint itself contains some allegations against the sufficiency of the mortgage given to secure the bonds, which are conclusively contradicted and qualified by the terms of the mortgage and bonds which are made a part of the complaint. For instance, it is alleged "that said bonds were not secured by a first mortgage or any other mortgage upon the property and franchises of the United States Carbonate Company." This allegation is utterly at variance with the terms of the mortgage, and this contention seems to have been abandoned.

It is also alleged that at the time of the execution of the mortgage the mortgagor owned valuable franchises, etc., which were not included in any mortgage to the defendant as trustee, "although the said bonds purported to be secured by a mortgage to the defendant as trustee of all the property and franchises of the company." In opposition to this allegation each of the bonds in its body sets forth that it is secured by the mortgage in question, and makes express reference to said mortgage for a description of the property and franchises mortgaged, etc., thus by reference specifically indicating the nature and extent of the property conveyed.

There is no allegation in the complaint that the defendant was in any manner a party to or responsible for having the indorsement upon

the bonds that they were first mortgage bonds, or that it in any manner was guilty of fraud or misrepresentation in connection with said statement or that it suppressed any knowledge or in fact knew that said bonds were not first mortgage bonds. Upon the other hand, it is to be noted as bearing upon this point that the resolutions passed by the mortgagor, authorizing the execution of the mortgage and bonds, expressly provided that the proceeds thereof should be applied to the payment and satisfaction of any existing indebtedness of the company. If this resolution had been complied with the prior mortgage would have been retired when the bonds were issued and the latter would have been in reality first mortgage liens.

Therefore, we are presented with the narrow question whether the defendant, solely on account of the certificate which it placed upon the bonds, should be held to have guaranteed the nature and extent of the security therefor, because the mortgagor had placed upon them a statement purporting to be descriptive of the latter. This, of course, involves a consideration of the terms of the certificate which the defendant executed, for plaintiff's complaint is based upon nothing else. As already indicated, we think that it would be unreasonable to impose upon defendant any such liability. The language employed when interpreted in its natural and ordinary meaning simply amounts to a statement identifying the bond whereon it is written as one of those mentioned in the mortgage, and the effect of this is an assurance to the purchaser that his bond is amongst those entitled to the benefits and protection afforded by such mortgage. But the statement does not upon any reasonable construction, in the absence, as in this case, of any allegation of fraud or deceit, active or passive, make the trustee a guarantor of the quality and extent of the security given by the mortgage, or responsible for the accuracy of statements indorsed upon the bond by the mortgagor purporting to describe the nature of such security. This is as plain upon a mere reading of the certificate as it could be made by any extended argument or reasoning. There is involved the construction of very few and simple words, and we could not reach the views urged by plaintiff through any justifiable course.

It is not necessary to consider various clauses found in the mortgage and referred to by defendant as exempting it from liability as a trustee. Some of those clauses manifestly refer to duties entirely different from those which would arise in connection with this certificate, and we do not intend to determine how far such clauses might serve to relieve a trustee like defendant from liability otherwise incurred. It is sufficient for the purposes of this case to determine as we do that the certificate upon which plaintiff's claim to a cause of action must rest does not sustain that claim.

The judgment should be affirmed, with costs.

Judgment affirmed.

DOYLE v. CHATHAM & PHENIX NATIONAL BANK

Court of Appeals of New York, 1930.
253 N.Y. 369, 171 N.E. 574, 71 A.L.R. 1405.

[Appeal from a judgment of the Appellate Division of the Supreme Court, affirming a judgment in favor of defendant entered upon a decision of the court at a Trial Term, a jury having been waived.]

KELLOGG, J. The plaintiff is the owner of "Collateral Trust Gold Bonds" executed by the Motor Guaranty Corporation, a Delaware corporation. Certain bonds were issued directly to the plaintiff for value paid; others were issued for value to persons from whom the plaintiff purchased. The bonds are expressed to have been issued in pursuance of the provisions of a certain indenture of trust entered into between the Motor Guaranty Corporation and the defendant, the Chatham & Phenix National Bank of the City of New York, as trustee. Each of the bonds bears a certificate, signed by the defendant as trustee, which reads as follows: "This bond is one of the series of bonds described in the Collateral Trust Indenture mentioned therein." The securities pledged by the Motor Guaranty Corporation to protect its bond issue, which were deposited with the defendant as trustee, have proven worthless, and the bonds are uncollectible. The plaintiff, as assignee of all causes of action accruing to the persons from whom he purchased, and in his own right, brings this action to recover from the defendant trustee the losses sustained, on the ground that its certificates were issued negligently and without authority, and that the plaintiff and his assignors were thereby induced to acquire worthless bonds and pay value therefor.

The collateral trust indenture was executed on the 1st day of February, 1922. It recites that the Motor Guaranty Corporation proposes from time to time to issue its collateral trust gold bonds, to draw interest at 8 per cent. payable semiannually; that each bond is to be written in accordance with a form of bond set up in the indenture. This form, with which the bonds of the plaintiff comply, contains the statement that the bond is "secured by the trade acceptances or notes of dealers, guaranteed by the Motor Guaranty Corporation; cash or notes of purchasers in part payment for motor vehicles, or other first lien mortgages, such purchasers' notes being endorsed by dealers and guaranteed by the Motor Guaranty Corporation." It also contains the following: "This bond is secured by said collateral of a face value of at least one hundred and ten per centum (110%) of the principal amount of the bond." It also states: "This bond shall not be valid for any purpose until the Trustee's certificate endorsed hereon shall have been duly executed." The form of the prescribed certificate, to be signed by the defendant as trustee, is identical with each of the certificates attached to the plaintiff's bonds, the reading of which has already been given.

The indenture provides that bonds shall from time to time be executed by the Motor Guaranty Corporation and delivered to the defendant as trustee for authentication by it; that the delivery shall

be accompanied by a request, signed by an appropriate officer of the corporation, stating the amount, date, and denomination of bonds to be issued, and demanding authentication of the bonds requested to be issued. It further provides that the trustee shall thereupon, without further action by the corporation, authenticate the bonds and deliver them back to the corporation, "provided, however, there shall be delivered to and pledged with the Trustee" certain named collateral. The collateral to be pledged is as follows: "(a) Cash or current funds, and/or (b) Trade acceptances or notes of dealers guaranteed by the Motor Guaranty Corporation, or notes of purchasers in part payment for motor vehicles, or other first lien mortgages, such purchasers' notes being endorsed by dealers and guaranteed by the Motor Guaranty Corporation." It also provides: "The aggregate principal amount of cash and/or of securities delivered and pledged under subsection (b) shall always be at least equal to 110% of the amount of the Bonds to be issued hereunder in respect thereto." It further provides: "Upon receipt of cash and/or notes, and/or first lien mortgages, all as provided and described in this article, the Trustee shall be fully protected and is authorized without further inquiry, to authenticate and deliver the Bonds specified in such requests and shall in no way be responsible to see to the application of the proceeds of any such Bond."

The indenture further provides that the trustee may require from time to time that the corporation furnish a certificate or certificates of the president or a vice president, attested by the secretary or assistant secretary, under the corporate seal, setting forth all or any information "concerning names and addresses of makers, acceptors, and other pertinent data regarding such collateral and/or first lien mortgages, such lists, descriptions and tabulations of collateral delivered or to be delivered to the Trustee." It contains this: "Such certificate or certificates shall be conclusive evidence to the Trustee of all statements therein contained and full warrant and protection to it for any and all action taken on the faith thereof under the terms of this indenture."

During the year 1922, the Motor Guaranty Corporation delivered to the defendant, for its certification as trustee, bonds of an aggregate par value in excess of $110,000. The defendant executed the requested certificates and returned the bonds to the corporation, which issued them to various persons upon payment of value therefor. Among these bonds were the bonds now owned by the plaintiff. In January, 1923, the corporation defaulted in the payment of interest and the defendant resigned as trustee. The fact then appeared that the corporation had, during the course of the year 1922, deposited with the trustee, as collateral for the bonds certified by it, the notes of various persons or corporations expressing an aggregate par value in excess of $130,000, all of which, with the exception of one note for $300, were in fact utterly valueless. With the same exception, none of the notes given were for the purchase of an automobile; none were made by an automobile dealer, or, for that matter, by a dealer in goods, wares, and merchandise of any description. The makers comprised a lawyer, a bond salesman, a ticket agent, a mining

corporation, and a construction company. The maker of two notes, aggregating $75,000, had no occupation, business, or other visible means of support, although judgments in excess of $900,000 were outstanding against him. None of the securities held by the trustee defendant, at the time the bonds now owned by the plaintiff were issued, with the exception noted, were the notes or acceptances of dealers or automobile purchasers. Subsequently to January, 1923, all the assets of the Motor Guaranty Corporation were sold for the sum of $143.30.

We agree that the defendant cannot be held as the guarantor of the sufficiency or legality of the securities pledged with it, or for negligence in not ascertaining that the securities were worthless. Tschetinian v. City Trust Co. of New York, 186 N.Y. 432, 79 N.E. 401; Green v. Title Guarantee & Trust Co., 223 App.Div. 12, 227 N.Y.S. 252, affirmed 248 N.Y. 627, 162 N.E. 552; Byers v. Union Trust Co., 175 Pa. 318, 34 A. 629; Jones on Corporate Bonds & Mortgages, § 287a. "The purpose of the certification was not to insure the sufficiency of the security. It was to prevent an over issue." Ainsa v. Mercantile Trust Co. of San Francisco, 174 Cal. 504, 512, 163 P. 898, 901. If the defendant, without investigation, chose to lend its name to the swindling operations of a bogus finance corporation, by acting as its trustee and certifying its bonds, provided it certified with authority and without actual knowledge of the fraud intended, it was well within its legal rights. The question before us for decision is this: May the defendant be held in damages if, without authority, it certified the bonds now owned by the plaintiff, thereby inducing the plaintiff and his assignors to advance moneys upon the faith of securities which were worthless?

It is clear that the defendant signed the certificates without authority. As we have seen, it was authorized to certify, "provided, however, there shall be delivered to and pledged with the Trustee" certain securities. The securities enumerated were the acceptances or notes of dealers or automobile buyers. No such securities were ever delivered to the defendant. If the defendant had requested and obtained a statement from the appropriate officers of the corporation, certifying to the "pertinent data regarding such collateral" possessed by them, its authority, without further investigation, to execute the certificates could not have been questioned. However, it requested and received no such statement. Its authority therefore remained conditional upon the fact that the notes of dealers had been precedently deposited with it. No such securities having been deposited, it had no authority to execute the certificates. * * *

In Conover v. Guarantee Trust Co., 88 N.J.Eq. 450, 102 A. 844, the opinion was expressed that the right of the takers of the bonds to recover damages from the trustee, on account of its unauthorized certification, rested upon a breach of the duty owed by the trustee to the takers as cestui que trustent. A similar view was expressed in Rhinelander v. Farmers Loan & Trust Co., 172 N.Y. 519, 65 N.E. 499, where the court said of the acceptance by the trustee of its trust position: "In executing that acceptance the defendant created the relation

of trustee and cestuis que trustent between it and the future bondholders." Notwithstanding these expressions, it is obvious that a trustee, in wrongly certifying bonds to prospective takers, in order that they may become cestui que trust, cannot, at that moment and before the relationship is established, have violated a trust duty owed to them. Manifestly this is true: "There is no trust or other relation between a trustee and a stranger about to deal with a cestui que trust." Lindley, L. J., in Low v. Bouverie, L. R. [1891] 3 Ch. 82, 99. In Mullen v. Eastern Trust & Banking Co., 108 Me. 498, 81 A. 948, the court held that an unauthorized certificate executed by a trustee was a false representation that the bond was properly issued, rendering the trustee liable upon a cause of action in deceit. The fact that the representation was innocently made was not material, said the court, since the trustee, by its certificate, made an assertion of fact which, according to information which was or should have been within its own knowledge, was not true. In the case before us, however, it is clear that the plaintiff may not recover damages for a false representation, as in an action for deceit. In the first place, no such cause of action is alleged. In the second place, there is no proof that the trustee, in issuing its certificates, intended to defraud the plaintiff or his assignors. "Intentional fraud, as distinguished from a mere breach of duty or the omission to use due care is an essential factor in an action for deceit." Kountze v. Kennedy, 147 N.Y. 124, 129, 41 N.E. 414, 29 L.R.A. 360, 49 Am.St.Rep. 651; Reno v. Bull, 226 N.Y. 546, 124 N.E. 144.

That there may be liability for damages resulting from the negligent utterance of words is now the settled doctrine in this jurisdiction. Glanzer v. Shepard, 233 N.Y. 236, 242, 135 N.E. 275, 277, 23 A.L.R. 1425; International Products Co. v. Erie R. R. Co., 244 N.Y. 331, 155 N.E. 662. * * *

The defendant here like the defendant in Glanzer v. Shepard, supra, occupied an independent position, and issued its certificates at the behest of a third person. We may say with Judge Cardozo that the certificates were made "with the very end and aim of shaping the conduct of another." Like the utterer of the statement in the assumed case in Lord Herschell's exception, it was the "special province" of the defendant "to know a particular fact"; it imparted information, by its certificates, to persons "desirous of ascertaining the fact for the purpose of determining" their course accordingly. Within the requirements laid down by Judge Andrews, the defendant knew that the certificates were desired for a serious purpose by persons who intended to rely and act thereupon. They were issued for the very purpose of establishing a relationship of trustee and cestui que trust between the defendant and the persons who might rely thereon. It must be remembered that this is not the case of a buyer and seller to whose transactions the principle of caveat emptor might apply. It is a case where the creator of a trust, accepted by the defendant, in a solemn instrument signed by both, named the defendant as trustee, for the special purpose, among others, that it might certify bonds to prospective investors, to the very end that the takers of the bonds might

receive definite assurance that the bonds were issued pursuant to the terms of the indenture. It seems clear, therefore, that, within the authorities cited, the defendant, in so far as its certificates constituted misrepresentations of fact, innocently though negligently made, became liable to the takers of the bonds, who invested their moneys upon the faith of the certificates.

The certificates were not to be issued, as we have seen, unless acceptances and notes of dealers and automobile buyers, in excess of bonds to be issued, had been deposited with the defendant as security therefor. Necessarily, therefore, the certificates constituted representations that the deposits had been made. Clearly, if the defendant, as trustee, had issued the certificates when no securities whatever had been deposited with it, liability for the damage done would have arisen. Equally must this follow where, as in this case, the securities deposited were not the securities specified in the trust indenture from which alone the defendant derived its power to certify. In not ascertaining that the securities deposited were not securities of the character named in the indenture, the defendant was guilty of negligence. In certifying the bonds, as issued pursuant to the terms of the indenture, it was guilty of negligently making a misrepresentation of fact. The plaintiff and certain assignors were induced by the certificates to invest in the worthless bonds. If the certificates had not been executed, the bonds could not have been issued and no loss would have accrued. Therefore the false certificates were the proximate cause of the losses sustained. Conover v. Guarantee Trust Co., supra; Mullen v. Eastern Trust & Banking Co., supra; Rhinelander v. Farmers' Loan & Trust Co., supra.

The provisions of the trust indenture in certain instances exempting the defendant from liability for its acts or omissions as trustee, do not, in this instance, apply. Conover v. Guarantee Trust Co., supra; Mullen v. Eastern Trust & Banking Co. supra; Rhinelander v. Farmers' Loan & Trust Co., supra. In Conover v. Guarantee Trust Co., supra, the vice chancellor said: "It accordingly seems impossible to construe an immunity clause as intended to exempt a trustee from liability for transcending his powers as clearly defined by the trust agreement; his engagement is to exercise the powers and only the powers conferred upon him, and the appropriate office and purpose of an immunity clause forming a part of a trust agreement which specifically and clearly defines the trustee's powers appears to be to limit his responsibility in matters of judgment and discretion committed to him in the execution of those defined powers."

The record indicates that the plaintiff and many of his assignors took their bonds in reliance upon the certificates and in ignorance of the character of the securities deposited. The plaintiff is entitled to recover damages on account of the investments thus induced, on the basis of the consideration paid therefor plus interest, less the value of the bonds acquired, if any. Reno v. Bull, supra. The record leaves it in doubt whether certain other assignors were not fully aware of the character of the securities deposited and of the shady nature of the financial transactions in which the Motor Guaranty Corporation was

engaged, and therefore whether or not they in good faith relied upon the certificates in making their investments. For the determination of these questions a new trial is necessary.

The judgment of the Appellate Division and that of the Trial Term should be reversed and a new trial granted with costs to abide the event.

Judgment reversed, etc.[8]

HAZZARD and others v. THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK.

Supreme Court of New York, 1936. 159 Misc. 57, 287 N.Y.S. 541.

[Action by bondholders to compel corporate trustee to replace valuable collateral securities, or, in lieu thereof, to pay damages to plaintiff.]

ROSENMAN, Justice. The defendant bank, by succession to the Equitable Trust Company of New York, became the trustee of an indenture of trust executed January 31, 1928, as of January 1, 1928. The indenture was executed by National Electric Power Company, and covered an issue of $10,000,000 of its debentures. There were deposited with the trustee, at the time of the execution of the trust indenture, as security for the debentures provided for thereunder, 85,000 shares of the common stock of New England Public Service Company, 155,989 shares of the common stock of Penn Central Light & Power Company, 29,993 shares of the common stock of Michigan Electric Power Company, and 44,986 shares of the common stock of Ohio Electric Power Company.

The trust indenture permitted substitution by the obligor of other securities for the securities originally deposited, under certain conditions to be hereinafter discussed. On December 18, 1931, the obligor made an application to the defendant as trustee to permit the substitution of 276,522 shares of class A common stock of National Public Service Corporation, and 444,868 shares of class B common stock of National Public Service Corporation for the aforesaid stock of Penn Central Light & Power Company, Michigan Electric Power Company and Ohio Electric Power Company. On December 21, 1931, the defendant bank granted the application; and on that date delivered to the obligor the shares of Penn Central Light & Power Company, Michigan Electric Power Company, and Ohio Electric Power Company, which it held, and received in place thereof the aforesaid shares of class A and class B common stock of the National Public Service Corporation.

These plaintiffs are some of the owners and holders of the debentures of National Electric Power Company which were covered by the trust indenture. They complain of this substitution. They allege that the defendant bank was guilty of bad faith and gross negligence in per-

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[8] Posner, The Trustee and The Trust Indenture: A Further Study, 1937, 46 Yale L.J. 737, 741–743; 1931, 31 Col.L.Rev. 858; 1931, 15 Minn.L.Rev. 477; 1930, 40 Yale L.J. 138. See, also, Note, 1931, 5 St.John's L.Rev. 108; 1931, 29 Mich.L.Rev. 355.

mitting it. In the month of July, 1932, National Public Service Corporation went into bankruptcy, so that the substituted stock became concededly worthless. On the other hand, the stock which the defendant permitted the obligor to withdraw is still concededly of substantial value. The obligor of the debentures, National Electric Power Company also became bankrupt; so that the plaintiffs can look only to the security under the indenture for payment of their bonds. The plaintiffs by this action seek to compel the trustee to replace the valuable securities surrendered, or, in lieu thereof, to pay the damages caused to the holders of the $10,000,000 of bonds as a result of this substitution.

The prospectus on which these debentures were sold states that they are secured by the deposit of the enumerated stocks "under and subject to the provisions of the indenture." The debentures themselves refer to the indenture for "a description of the property pledged" and "the nature and extent of the security." Although these plaintiffs did not examine the trust indenture, and although it is a matter of common knowledge that purchasers of debentures of this type secured by a trust mortgage seldom, if ever, examine the terms of the trust indenture, it is well settled that debenture holders are legally bound by the terms of the indenture.[3] Benton v. Safe Deposit Bank of Pottsville, 255 N.Y. 260, 174 N.E. 648. Its terms must therefore be considered. * * *

The company was given the right to withdraw any securities under the trust indenture and to substitute therefor other securities, providing only that the earnings applicable to paying the interest under the indenture from all of the securities remaining on deposit with the trustee after the substitution, for a period of twelve consecutive calendar months within the fifteen calendar months immediately preceding the application for substitution, shall have been at least twice the interest requirements for a period of one year. In view of the fact that the interest requirements for one year of the $10,000,000 of debentures was $500,000, it was necessary to present an earnings certificate of the securities remaining on deposit after the substitution, showing earnings of at least $1,000,000 for any one year within the preceding fifteen calendar months prior to December 18, 1931.

The form and content of the earnings certificate referred to in the above clause is prescribed in article I, § 4, of the indenture. The actual substitution of securities was handled by Mr. Buckley, a trust officer of the defendant. The draft of the application, together with the earnings certificate, was submitted to him on December 18th. After checking these papers with the terms of the indenture, he sent them over to the counsel for the bank for such correction as the counsel might deem to be necessary. Counsel made a few unimportant verbal corrections, had a conference with counsel for the obligor on December 21st, and on that day the application was approved in final form by counsel. On the same day, the securities were substituted. The trust officer testified as to his own ignorance of the affairs of National

3 See, Drinker, Concerning Modern Corporate Mortgages, 1926, 74 U. of Pa.L.Rev. 360; Notes, 1935, 83 Mich.L.Rev. 604, 1084; 1940, 25 Wash.U.L.Q. 473.

Public Service Corporation and National Electric Power Company. He did not know that the latter was a debtor of the bank or that the officers of the Insull system were debtors. He stated that the substitution was handled by him alone, supervised only as to legal details by counsel for the bank. He testified that, so far as he knew, no other officer of the bank was concerned with the substitution or had any thing to do with it.

Although the plaintiffs have urged that it is highly improbable that a transaction of so large an amount could have been handled exclusively by a subordinate officer in the trust department, receiving a salary of $7,200, without some direction or order from a superior officer, nevertheless there is no evidence on which the court can make an inference of fact that the substitution was ordered or directed by any superior officer in the bank.

Article 15 of the trust indenture specifies the terms and conditions under which the trustee accepts the trust.

Section 5 of such article reads as follows: "Section 5. The Trustee may execute any of the trusts or powers hereof and perform any duty hereunder, either itself or by or through its attorneys, agents or employees, and it shall not be answerable or accountable for any act, default, neglect, or misconduct of any such attorneys, agents or employees, if reasonable care has been exercised in the appointment and retention thereof, nor shall the Trustee be otherwise answerable or accountable under any circumstances whatsoever, except for its own gross negligence or bad faith."

Sections 9 and 10 of the indenture read in part as follows:

"Section 9. The Trustee shall be protected in acting upon any notice, resolution, request, consent, order, certificate, report, opinion, bond, or other paper or document believed by it to be genuine and to have been signed or presented by the proper party or parties. The Trustee may consult with counsel and the opinion of such counsel shall be full and complete authorization and protection in respect of any action taken or suffered by it hereunder in good faith and in accordance with the opinion of such counsel and such action so taken or suffered shall be conclusive and binding upon the Company and on all holders of bonds issued under this Indenture. * * *

"Section 10. Upon any application * * * for the execution of any release, or upon any other application to the Trustee hereunder, the resolutions, certificates, statements, opinions, reports and orders required by any of the provisions of this Indenture to be delivered to the Trustee as a condition of the granting of such application may be received by the Trustee as conclusive evidence of any fact or matter therein set forth and shall be full warrant, authority and protection to the Trustee in acting on the faith thereof, not only in respect of the facts but also in respect of the opinions therein set forth; and before granting any such application the Trustee shall not be bound to make any further investigation into the matters stated in any such resolution, certificate, statement, opinion, report or order, * * *; but it may in its discretion make any such independent inquiry or investigation as it may see fit. If the Trustee shall determine * * *

to make such further inquiry, it shall be entitled to examine the books and records of the Company, either itself or by agent or attorney; and unless satisfied, with or without such examination, of the truth and accuracy of the matters stated in such resolutions, certificate, statement, opinion, report or order, it shall be under no obligation to grant the application. * * * The reasonable expense of every such examination shall be paid by the Company. * * * "

The obligor, National Electric Power Company, was one of the major holding companies near the top of the so-called Insull System, and dominated the Insull empire in the eastern part of the United States. It owned practically all of the shares of stock of the National Public Service Corporation. Above it was the Middle West Utilities Company which in turn was controlled by two other companies, viz., Corporation Securities Company of Chicago and Insull Utilities Investments, Inc., which were in turn controlled by the Insull family. The National Public Service Corporation was likewise a holding company, and did not itself operate any utilities. It had its own senior issue of stock and its own funded indebtedness and separate creditors. Below the National Public Service Corporation there were a veritable maze of subholding companies and sub-subholding and operating companies. The Ohio Electric Power Company, the Penn Central Light & Power Company, and the Michigan Electric Power Company were all operating companies, and the stock of each of them, before the substitution, was held by the National Electric Power Company directly. The management and directorship of the various holding companies were the same; so that in effect, the Insulls dominated the entire system, transferring and shifting loans, collateral, debits, and credits from one company to another virtually at will.

The defendant, while acting as trustee for these bondholders, was also a large creditor of the obligor, in fact its largest single creditor. It had loaned considerable sums of money from time to time to the National Electric Power Company without collateral. This loan was increased to $6,000,000 on June 19, 1931, and at about that time the defendant received collateral therefor. It is obvious that the defendant, as a creditor of the obligor, occupied a position inconsistent with its role as a trustee under the indenture. In addition, the principal officers of the obligor and of the other companies of the system were heavily indebted to the defendant upon obligations which were past due on the date of the substitution, and some of which were under-collateralized and uncollectible. For example, on that date Martin Insull who was the vice chairman and executive director of National Electric Power Company, owed the defendant $4,250,000. Ziegler, the vice president, and Reid, the president of National Electric Power Company, both of whom were directors, were similarly indebted to the Chase National Bank in large amounts. The total of loans to the Insull group was $12,520,000. The collateral for all of these loans were securities of some part of the so-called Insull System. Corporation Securities Company, the ultimate stockholder of the obligor, owed the defendant $500,000 which it could not pay. The ramifications of various holding companies subholding companies, sub-subholding

companies, involved in this system need not be here described in detail. The records of the bank indicate that the bank itself considered the loans to the various companies and corporate officers in the Insull System, all in the general category of Insull loans.

For its services as trustee under the indenture, the bank received an annual fee of $1,100 or $1,200.

The Chase National Bank is a very large banking and trust institution, divided into many distinct departments. It has some forty or fifty vice presidents. Its trust department is apparently operated as a separate unit of the bank. The business of this department was confined to trust matters, and is carried on at 11 Broad street in New York City. The banking department is located at 18 Pine street in New York City.

Mr. Makepeace was a vice president of the defendant, connected exclusively with its banking department and not with its trust department. He was not conversant with the affairs of the trust department, and his duties had nothing to do with the trust department. His duties, so far as the bank is concerned, were confined to supervision of the mercantile branch of the banking department and to the making of loans at the head office.

Makepeace was at the same time a director of the National Electric Power Company and a director of the National Public Service Corporation. He was also a member of the executive committee of National Public Service Corporation. He had been a member of these boards during all the time he had been an officer of the Equitable Trust Company, the original trustee, and of the defendant Chase National Bank, the substituted trustee.

The evidence is in conflict as to whether or not Makepeace's service on the boards of the National Electric Power Company and National Public Service Corporation was in the capacity of an agent of the bank or not. Although it does not appear that he was specifically requested to go on these boards by the defendant, I find as a fact that he purported to represent the defendant's interests where it was necessary or advisable to do so while on these boards. The inference from the evidence is that the defendant considered Makepeace to a great extent the liaison between the National Electric Power Company and the National Public Service Corporation, on the one hand, and the defendant on the other. To the degree that it was necessary, and as occasion required, Makepeace was the guardian of the bank's interests as a creditor of the two companies. * * *

With respect to the first contention of the plaintiffs, I find that the plaintiffs have not sustained the burden of proving that the trustee sought to obtain profit for itself at the expense of its debenture holders by its action in allowing the substitution, or that it was actuated in any way by bad faith. * * *

Have the plaintiffs' contentions of gross negligence on the part of the defendant been sustained, in spite of the various exculpatory clauses with which this indenture fairly bristles?

It is clear that if it were not for the terms of the indenture, the defendant could not escape the conclusion that it was negligent towards

its bondholders. If the relationship between this so-called trustee and these plaintiffs were the ordinary common law fiduciary relationship, and if the trust instrument did not exempt the defendant from every duty of making reasonable inquiry, the acts of the trustee would be a distinct violation of the well-recognized obligations arising from such relationship. It is elementary that a trustee owes to its fiduciary at least the duty of exercising the same care and prudence that a reasonable man would exercise with respect to his own property. Without going into all of the details of the evidence, the conclusion is irresistible that, apart from the general and specific exculpatory clauses, the defendant was guilty of lack of reasonable care in accepting these substituted securities without further investigation, with all of the knowledge which is attributable to it through its vice president Makepeace, and through its other officers and investment files. The fact that the substituted securities were removed so many times from the actual earnings of the operating companies, whereas the withdrawn securities were those of operating companies themselves; the fact that the debentures of National Public Service Corporation were themselves selling as low as 36, or a little over one-third of par; the fact that the country was then in the midst of a financial debacle; the precipitous decline in utility earnings; the fact that so many of the assets carried on the balance sheets would have no value on liquidation; the decline in the bank balances of these corporations; the fact that the bank's investment and credit files showed that the common stock of National Public Service Corporation was a highly speculative investment, and, indeed that the gold debentures of such corporation "occupy a speculative position and must be regarded as undesirable for conservative investment purposes"; the execution by the defendant of the so-called "stand-still" agreement of December 16, 1931, which extended the loans of Corporation Securities Company; the knowledge of the close connection and interdependence financially between said Corporation Securities Company and the other holding companies of the Insull System; the fact that the cash position of National Public Service Corporation was so low that it had to borrow money on the lives of its officers; the more precipitous decline in the value of the securities of holding companies as compared with those of operating companies; the inconsistent position of the bank as a creditor of the National Electric Power Company—the total of all of these, and other facts in evidence, it can fairly be concluded, would have deterred a reasonably careful person from giving up the securities of the three operating companies for those of more doubtful value of the holding company, if he were managing his own property, or if he were a common-law trustee not protected by the clauses of this indenture.

With this trust indenture and the exculpatory clauses thereof, however, a different picture is presented. Similar exculpatory clauses have been upheld time and again as valid and not contrary to the public policy of this state. Benton v. Safe Deposit Bank of Pottsville, 255 N.Y. 260, 174 N.E. 648; Green v. Title Guarantee & Trust Co., 223 App.Div. 12, 227 N.Y.S. 252, affirmed 248 N.Y. 627, 162 N.E. 552; Hunsberger v. Guaranty Trust Co. of New York, 164 App.Div. 740,

150 N.Y.S. 190, affirmed 218 N.Y. 742, 113 N.E. 1058; Greene v. Continental Bank & Trust Co. of New York, 267 N.Y. 519, 196 N.E. 559. In the Benton case, the duty of the trustee was held to be strictly measured and limited by the agreements contained in the indenture. The court referred to the slight financial remuneration which the trustee bank received in the transaction, and came to the conclusion that "the bank was merely prudent and cautious in limiting its liability and defining its duties."

The defendant here not only generally restricted its liability to gross negligence and bad faith, but practically in every way and at every turn, specifically limited and prescribed its duties, obligations and responsibilities. For example, section 9 of article 15, above quoted, protected the defendant in acting upon any certificate or other paper or document believed by it to be genuine. The same section gave it protection in respect of any action taken by it pursuant to the opinion of counsel. The succeeding section provided that certificates accompanying applications for release of securities "may be received by the trustee as conclusive evidence of any fact or matter therein set forth * * * not only in respect of the facts, but also in respect of the opinions therein set forth." The same section relieved the trustee in specific terms from any duty "to make any further investigation into the matters stated in any such resolution, certificate, etc."

The defendant in the case at bar is protected by the trust agreement from any liability in relying, as he did, upon the certificates furnished. As pointed out in 42 Harvard Law Review, 198, at page 215, in discussing the ordinary clauses in trust agreements for substitution of security, "such releases and exchanges are usually regulated by reports and certificates of officers, appraisers, and the like, and, generallly speaking, afford full protection to the trustee who acts thereon in good faith even though loss be occasioned by the release."

Of course, a trustee's power to release or substitute collateral can arise only from the terms of the indenture itself. Apart from the authority contained therein, a trustee concededly has no right to release or substitute any collateral. Colorado & S. R. Co. v. Blair, 214 N.Y. 497, 108 N.E. 840, Ann.Cas.1916D, 1177; Conover v. Guarantee Trust Co., 88 N.J.Eq. 450, 102 A. 844, affirmed 89 N.J.Eq. 584, 106 A. 890. This trust indenture clearly permitted the obligor to substitute collateral upon certain specified terms and conditions.

Can there be implied here, in spite of these exculpatory clauses, a common-law trust relationship, so that the usual legal consequences thereof will attach independently of the provisions of the trust indenture? The courts of some states have made such implication, and have held the trustee to a fiduciary's duty in spite of the various verbal devices used to free it from such responsibility. Marshall & Ilsley Bank v. Guaranty Investment Co., 213 Wis. 415, 422, 423, 250 N.W. 862; State v. Comer, 176 Wash. 257, 263, 264, 28 P.2d 1027; 33 Columbia Law Rev. 97, 98, note 3. See 42 Harvard Law Review 198, 244. The courts of other states have taken the opposite position. See 33 Columbia Law Review, 97, 98, and cases cited in note 4 thereof.

Irrespective of holdings or tendencies in other jurisdictions, it is now the well-settled doctrine of this state that so long as the trustee does not step beyond the provisions of the indenture itself, its liability is measured, not by the ordinary relationship of trustee and cestui, but by the expressed agreement between the trustee and the obligor of the trust mortgage. Where the terms of the indenture are clear, no obligations or duties in conflict with them will be implied. * * *

Therefore the rule of trustee and cestui is not the one to be applied here, either by agreement or implication. The question is, therefore, whether gross negligence as hereinabove defined has been committed under the terms of the indenture.

I am constrained to conclude that the defendant was not guilty of that kind of gross negligence, in view of the fact that everything which it did was specifically permitted, and that everything which it failed to do was specifically excused, by the express provisions of the trust indenture itself. Although the defendant was negligent, as judged by the standards of care imposed upon a common-law trustee, it cannot be said that under the language of the indenture it was guilty of willful passivity or of reckless disregard of the rights of the debenture holders when, in fact, it complied with every detail of its contractual duty.

Nor can it be said that Makepeace's knowledge, imputed to the defendant, brands its conduct as grossly negligent as herein defined. A consideration of the facts before him does not lead to the conclusion that the substitution was permitted with willful or reckless disregard of the rights of the bondholders, when the various permissive and exculpatory provisions of the indenture are borne in mind.

The facts of this case show, perhaps as clearly as can be imagined, how utterly unjust to the investing public is the modern trust indenture. Prospective investors are unquestionably induced to purchase debentures, to a great extent, by the name and prestige of the trustee, which are capitalized by the obligor seeking financing in order to sell its securities. It is safe to assume that many investors in these debentures of National Electric Power Company were led to purchase them, in large measure, by the fact that the Chase National Bank, or its predecessor, with all of its power and prestige in the financial community, was named as trustee. While it is true that our courts have, unrealistically, held purchasers to a knowledge of the terms of the indenture, the fact cannot be avoided that seldom, if ever, is the indenture read by such purchasers. It is, indeed, doubtful whether they understand that they should read it, or whether reading it would lead to comprehension of its significance. Reliance is placed almost completely upon the belief that the experience, power, financial acumen and integrity of the trustee will serve as a protection. Nor does it appear that repeated warnings by the courts will cause more persons to read indentures in the future than in the past. The untrained investor unquestionably depends upon the great financial institution named as trustee to supply the skill and the watchfulness and the prudence and the experience which he himself lacks. The cruel fact is that not only is the trustee not required to exercise that greater

skill and watchfulness and prudence and skill which it has, but it is even absolved from exercising merely the ordinary care which a single individual should exercise as to his own affairs.

Billions of dollars have been invested on the strength of indentures such as the one involved in this case. This defendant alone, at the time of the substitution, was acting as trustee under 850 similar indentures, totaling about $5,000,000,000.

In such indentures the use of the word "trustee" is clearly a misnomer. The corporate trustee has very little in common with the ordinary trustee, as we generally understand the fiduciary relationship. The ordinary trustee is supposed to represent the interests of the beneficiary alone. The courts impose upon him an undivided loyalty to the cestui que trust. So strict is the rule of undivided loyalty to the beneficiary that the mere fact that a trustee has an interest inconsistent with the interest of his cestui, casts upon him the burdens of explanation and justification. Munson v. Syracuse, G. & C. R. Co., 103 N. Y. 58, 8 N.E. 355; Globe Woolen Co. v. Utica Gas & Electric Co., 244 N. Y. 483, 121 N.E. 378. The trustee under a corporate indenture, on the other hand, has his rights and duties defined, not by the fiduciary relationship, but exclusively by the terms of the agreement. His status is more that of a stakeholder than one of a trustee. Indeed, in the earlier indentures the documents were rather in the form of escrow agreements, and no duties were assigned to the trustee. See 33 Columbia Law Review, 97, 99. Far from refraining from occupying inconsistent positions, corporate trustees have affirmatively and deliberately assumed them to an increasing degree. Corporate trustees have come to act as promoters, underwriters, bankers, financial advisers, bondholders, and creditors of companies whose debenture holders they have been selected to protect. 42 Harvard Law Review, 198, 226.

It is becoming increasingly clear that these indentures, though legally permissible, have all the potentialities of fraud upon innocent investors. A recent study by the Legislature of the state of New York has revealed how widespread has been the damage caused to investors by such indentures, even in the restricted field of real estate, and how impossible it has been to secure relief in the courts. See Report of Legislative Investigating Committee to Investigate Bondholders' Committees, etc. (Legislative Document No. 66, 1936, page 18 et seq.)

This indenture was particularly vicious. It permitted the substitution of practically all the collateral, on the bare statement of officers of the obligor as to earnings. It made unnecessary any check-up by an impartial agency. It rendered unnecessary any consideration on the part of the so-called trustee to the comparative value and soundness of the substituted collateral. It placed in the hands of the obligor the power to wipe out completely the security behind its debentures. No check or restraint of any appreciable force was provided. The clauses permitting substitution are so astutely tucked away that the average layman would have the greatest difficulty in discovering them. Not only the average layman, but seasoned financial experts like those who publish Moody's Manual apparently overlooked the power of substitution, for until after the collapse of the system, Moody's Manual,

in describing these bonds and the security behind them, never mentioned the power or possibility of substitution of collateral.

The defendant contends, as do financial institutions generally, that the fees usually received for acting as "trustees" under these indentures are not adequate if the duties of an ordinary fiduciary are to be assumed. That may be true. Conversely the fee of $1,100 per year in this case was grotesquely exorbitant for the negligible services performed and responsibility undertaken by the defenant. The defendant did not earn its fee either in work or in risk. It would be far better for the bondholders to pay a much larger compensation to the trustee, and be able to insist upon the usual vigilance of a fiduciary. The trustee need not become an insurer any more than, for example, a testamentary trustee. But the trustee should be made to live up to the responsibilty which nearly every purchaser assumes it has, and which it represents to the public as having undertaken, in a sense, by the very advertisement of the designation "trustee."

Such change can come in this state only through action by the Legislature. Trustees have accepted duties under these indentures, slight as they are, relying upon judicial precedents absolving them from exercising ordinary care, and permitting them to insert practically unlimited exculpatory clauses. The rules which have been laid down by the courts can obviously not be altered now by the courts in justice to trust agreements which have been made in reliance upon them. The entire system, however, should be changed by legislation so as to provide more adequate compensation to the trustee, imposition of a duty of active vigilance akin to that placed upon ordinary fiduciaries. Legislation to such end, applicable only to real estate trust mortgages however, is now pending before the Legislature. Ass.Intro.No.1880 Print No. 2779 by Mr. Streit. Particularly, the right of release or substitution of collateral should be carefully circumscribed. If the trustee itself is not required to assume any duty of vigilance with respect thereto, certificates should be required of disinterested appraisal experts, not only as to earnings but as to value, and, indeed, as to every other item which banking experts consider important in measuring the desirability of collateral.

I am reluctantly constrained to conclude that the defendant has successfully exempted itself from liability in this sad picture of high finance. For the inexcusable terms of the indenture, the trustee cannot be held accountable. It performed in full the negligible duty which was imposed upon it by the indenture. It did nothing more; but, having done that, it is absolved under the law.[4] * * *

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[4] Aff'd without opinion, 257 App.Div. 950, 14 N.Y.S.2d 147, 1st Dept., 1939; 282 N.Y. 652, 26 N.E.2d 801, 1940; motion for reargument or to amend remittitur, denied, 283 N.Y. 682, 28 N.E.2d 406, 1940.

Rodwin, Trustees under Indentures—The Old Order Changes, 1937, 3 Corp.Reorg. 223, 225–228; Note, 1936, 46 Yale L.J. 97, esp. 109–112. See, also, Hatch, A Form of Depression Finance—Corporations Pledging Their Own Bonds, 1934, 47 Harv.L.Rev. 1093; Jacob, The Effect of Provision for Ratable Protection of Debenture Holders in Case of Subsequent Mortgage, 1938, 52 Harv.L.Rev. 77; Note, Change of Security under the Corporate Mortgage, 1930, 44 Harv.L.Rev. 92; on restrictive covenants in debenture agreements against pledging and mortgaging corporate property, see Notes, 1930, 30 Ill.L.Rev. 487; 1936, 49 Harv.L.Rev. 620.

TRUST INDENTURE ACT OF 1939, 15 U.S.C.A. § 77ooo.

Duties and Responsibility of the Trustee—Duties Prior to Default.

(a) The identure to be qualified may provide that, prior to default (as such term is defined in such indenture)—

(1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and

(2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture; but such indenture shall contain provisions requiring the indenture trustee to examine the evidence furnished to it pursuant to section 77nnn to determine whether or not such evidence conforms to the requirements of the indenture.

Notice of defaults.

(b) The indenture to be qualified shall contain provisions requiring the indenture trustee to give the indenture security holders, in the manner and to the extent provided in subsection (c) of section 77mmm, notice of all defaults known to the trustee, within ninety days after the occurrence thereof: *Provided,* That such indenture may provide that, except in the case of default in the payment of the principal of or interest on any indenture security, or in the payment of any sinking or purchase fund installment, the trustee shall be protected in withholding such notice if and so long as the board of directors, the executive committee, or a trust committee of directors and/or responsible officers, of the trustee in good faith determine that the withholding of such notice is in the interests of the indenture security holders.

Duties of the trustee in case of default.

(c) The indenture to be qualified shall contain provisions requiring the indenture trustee to exercise in case of default (as such term is defined in such indenture) such of the rights and powers vested in it by such indenture, and to use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

Responsibility of the trustee.

(d) The indenture to be qualified shall not contain any provisions relieving the indenture trustee from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct, except that—

(1) such indenture may contain the provisions authorized by paragraphs (1) and (2) of subsection (a) of this section;

(2) such indenture may contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be

proved that such trustee was negligent in ascertaining the pertinent facts; and

(3) such indenture may contain provisions protecting the indenture trustee with respect to any action taken or omitted to be taken by it in good faith in accordance with the direction of the holders of not less than a majority in principal amount of the indenture securities at the time outstanding (determined as provided in subsection (a) of section 77ppp) relating to the time, method, and place of conducting any proceeding for any remedy available to such trustee, or exercising any trust or power conferred upon such trustee, under such indenture.

B. THE BONDHOLDERS

1. RIGHTS IN MANAGEMENT

BONDHOLDERS' RIGHTS IN MANAGEMENT

The position commonly assumed by the Bar is that prior to default or insolvency of the corporation, a bondholder or creditor has no right to equitable relief against the wrongful acts of the management. It is said that the bondholder is not a stockholder; is not a participant in the enterprise; and if he had any rights in management, has relinquished them in return for specific remedies by way of action at law or foreclosure of security in case of default.

Economically, it is not easy to see the reason why a distinction should be drawn between a bondholder and a preferred stockholder. However, there is an economic distinction between a long term creditor and a creditor such as a commercial banker, who grants short term credit. He is supposed to grant such credit on the strength of a good current ratio—that is on the strength of the fact that the current assets of the corporation are so much greater than its current liabilities that his note will be paid in any event, even though the management is inefficient and perhaps dishonest, or at least not working to the best interests of the participants.

But the holder of a long-term bond, like the preferred shareholder, will have his interest paid only if the corporation is well managed—that is, he must look primarily to the good faith and efficiency of the management rather than to the property. On foreclosure, the bondholder rarely, if ever, comes out whole. A foreclosure does not normally result in payment of a bond, but in its refinancing by the issue to the bondholder of another, and usually less desirable form of security. Consequently, unless the business is well managed he stands to lose quite as much as the preferred shareholder.

Both he and the preferred shareholder have a less vivid interest in the management; since the common stockholder or the holder of an unlimited participation has an interest, not merely in a minimum amount of return, but in getting the maximum amount of return possible in the way of corporate profits. The bondholder and the preferred shareholder normally are interested wholly in having the management good enough to secure a corporate profit sufficient to take care of their interest or preferred dividend requirements; and requirements for a sinking fund, if any; and to keep the property in good enough shape so that at maturity of the bond issue the debt can be refinanced or paid.

Broadly speaking, the rule of law might be stated as follows:

(1) Managements are under no fiduciary duties to bondholders so long as the corporation is not in default, but

(a) there is a remedy in equity to prevent waste or damage to the security mortgaged or pledged; and

(b) possibly, there may be an interest in preserving from waste or depreciation the margin of assets of the corporation over and above the bond issue. This last is extremely problematic.

(2) As soon as the corporation becomes insolvent—or possibly when insolvency is imminent, the management falls under a fiduciary duty to protect the creditors from threatened or further loss and, possibly also, to see that they are paid ratably.

This last rule, if it exists, is hazy in the extreme, though it is vigorously applied in a number of instances. It is sometimes said that when a concern is insolvent, its directors must manage its assets as a trust fund for the "benefit of creditors."

This, of course, summarizes a result; the statement cannot be said fairly to express the theory. Probably a better theory is that as soon as a corporation becomes insolvent, all creditors become joint adventures, i. e., since they cannot get paid according to the tenor of their claim, they must work together in order to secure either a ratable distribution or a continuance of the business which may ultimately pay them out. This last theory has never been passed on in the courts.[1]

WHITMORE v. INTERNATIONAL FRUIT & SUGAR CO.

Supreme Judicial Court of Massachusetts, 1913. 214 Mass. 525, 102 N.E. 59.

HAMMOND, J. The demurrers were overruled by a judge of the Superior Court, and the case is before us upon a report made by him under R.L. c. 159, § 27. If the order overruling the demurrers was erroneous, the bill is to be dismissed with costs, unless further amendment shall be allowed. If the order was right, the defendants are to answer over.

We adopt as a sufficiently full and accurate summary of the bill the one given by the judge of the Superior Court in his "memorandum of decision," which is in the following language:

"The bill as amended, in substance alleges:

"1. The entire property, 'for the most part barren or covered with woods,' of the International Fruit & Sugar Company, hereinafter called the Fruit Company, is included in a mortgage to the International Trust Company, hereinafter called the trustee, and does not exceed in value $50,000. There have been issued bonds secured by said mortgage to the par value of $400,000, of which amount bonds to the par value of $250,000 are still the property of the Fruit Company, but bonds to a par value in excess of $75,000 have been transferred to certain of the defendants as trustees of the Cuban-American Trust, of which amount bonds to a par value in excess of $40,000 are still in the possession of the persons named as trustees, either individually or as such trustees, and 'a large number' of the bonds have been sold by the Fruit Company to bona fide purchasers through false and fraudulent misrepresentations, set forth in detail, some of which were clearly statements as to existing facts.

"2. The individual defendants caused the Fruit Company to be organized as a fraudulent scheme for the purpose of transferring to it the property included in the mortgage at a grossly excessive price, and

1 Statutes in a few states permit corporations to confer voting power on its bondholders. See, Del.Rev.Code, 1935, § 29; La.Dart.Gen.Stat.1932, § 112; Mich.General Corporation Act, § 36; Nev.Hillyer's Comp.Laws, 1930, § 1706; Ohio Gen.Code, § 8623-77; Va.Michie Code, 1930, § 3808. See, also, Tracy, The Problem of Granting Voting Rights to Bondholders, 1935, 2 U. of Chi.L.Rev. 208.

of selling said bonds and the stock of the corporation by means of false and fraudulent representations, all as set forth in paragraphs 3, 4, and 5 of the amended bill. Recitals of subsequent action are made in said paragraphs. It seems that at the most these allegations and the recitals referred to are either preliminary to the main part of the bill or matters of inducement and not sufficient for the granting of relief.

"3. The plaintiffs, relying on said representations and believing them to be true, purchased for a valuable consideration, and still own, certain of the bonds.

"4. The individual defendants controlling the Fruit Company have caused it to transfer to themselves, individually or as trustees of the Cuban-American Trust, the bonds in excess of the par value of $75,000 as hereinbefore referred to without adequate consideration, and these transfers are alleged to be a fraud on the bona fide holders. These allegations are vague. But the individual defendants stand in a confidential or trust relation to the corporation. See paragraph 1 of the bill. These bonds in excess of $40,000 in par value are still in the possession of the defendants who are trustees of the Cuban-American Trust, individually or as such trustees.

"5. The individual defendants, as officers of the Fruit Company, have misappropriated money and property of that company and have fraudulently and for their own profit caused unfair and inequitable contracts to be entered into between it and three of their number as trustees for said Cuban-American Trust for the sale of the bonds of the company, which must be construed as including the bonds of the par value of $250,000 still owned by the Fruit Company, and it is alleged that said unfair and inequitable contracts have been secured by means of false and fraudulent representations. Many of these allegations are also somewhat indefinite.

"6. The Company is alleged to be insolvent, and on July 1, 1911, defaulted on the payment of the interest due on some of its bonds, and that default still continues as to some bonds including the bonds owned by the plaintiff Cadwell. The trustee has notice of said default and has been requested by the plaintiffs to commence proceedings for the foreclosure of the mortgage, but refuses so to do. The provisions of the mortgage as to foreclosure are set forth in paragraphs 11 and 12 of the amended bill.

"7. The individual defendants fraudulently plan to cause the Fruit Company to transfer five thousand acres of its lands, including its only valuable and income-producing property, without fair or adequate consideration, which if done by this insolvent corporation will seriously impair the security of its bonds. The trustee, it is alleged, intends to release this land from the mortgage, although it knows of the default on the interest of the bonds, without payment of the amount required by the mortgage.

"8. The mortgaged property is not sufficient to pay in full the bonds now in the hands of bona fide bondholders for value.

"To summarize in part: An insolvent corporation has issued mortgage bonds, a part of which have been sold by means of fraud. It still holds part of the bonds. The mortgaged property is not sufficient to pay the bonds already sold. There has been a default in interest

on the [a] part of the bonds, which default still continues. The individual defendants, the officers of said corporation, are improvidently at least endeavoring to sell bonds which will increase the amount of the bonded indebtedness and decrease the security for the bonds already sold. Notwithstanding its insolvency, the corporation, acting through the individual defendants, seek to sell the most valuable part of its property and to wrongfully take said part out from the security of the mortgage. The trustee declines to proceed for the protection of the bondholders."

The relief prayed for is substantially the foreclosure of the mortgage with appropriate proceedings to prevent the impairment of the value of the security of the bondholders either by fraudulent issue of additional bonds or by an improvident and unwarrantable sale of the land covered by the mortgage. There can be no doubt that at least to prevent such impairment the bill is maintainable whether the principal be due or not, or whether the coupons be paid or unpaid.

The bill is not multifarious. All the defendants were materially concerned, some in one way, some in another, with the matter of which the plaintiff complains, and it matters not that to a certain extent the particular acts of one are distinct from the particular acts of others, all tending to the same general result injurious to the plaintiff. See Parker v. Simpson, 180 Mass. 334, 341, 62 N.E. 401; Davis v. New England Railway Publishing Co., 203 Mass. 470, 89 N.E. 565, 25 L.R.A., N.S., 1024, 133 Am.St.Rep. 318.

The demurrers therefore could not have been sustained as a whole, and hence were rightly overruled; and that would be so even if they were sustainable as to some of the grounds alleged.

It follows that by the terms of the report the defendants are to "answer over"; and it is

So ordered.

HOYT v. E. I. DU PONT DE NEMOURS POWDER CO.

Court of Chancery of New Jersey, 1917. 88 N.J.Eq. 196, 102 A. 666.

BACKES, V. C. This bill is to restrain the use of corporate assets to retire capital stock, in impairment of the rights of bondholders. Round figures and approximate sums will be used to explain the controversy. The defendant the New Jersy Du Pont Company was a holding company until 1906, when it began manufacturing explosives and allied products. In that year it made a 4½ per cent. 30-year gold bond issue of $16,000,000, secured by a trust deed, imposing

"a charge in favor of the trustee upon all its present and future property, including all its lands, plants, factories, machinery, goods, patent rights, trade-marks, processes, improvements, and all other property, both real and personal of every name and nature whatsoever and wherever situated, and present and future net income, and earning profits for the benefit of said bonds."

Since then and particularly during the present world war, huge sums of money have been made out of military powder, and from a holding company of $37,500,000 of possessions, it had grown to a corporation of

over $200,000,000 of assets, when in 1915 the management decided to reorganize. The Delaware Du Pont Company was formed with an authorized capital of $240,000,000, and bought the Jersey company's property and business for $120,000,000; the price being paid by $1,500,000 cash, $59,500,000 debenture[2] shares, and $59,000,000 common stock of the Delaware company. The Jersey company used the cash to take up mortgage liens approximating that sum, and divided the $59,000,000 common stock among the holders of its $29,500,000 of common stock—a 200 per cent. dividend. The $59,500,000 debenture shares were calculated to retire all of the Jersey company's liabilities, consisting of the bond issue (then outstanding) $14,000,000, preferred stock $16,000,000, common stock $29,500,000. All but $1,000,000 of the bonds, and $300,000 of the preferred stock, have been retired, and there remains in the treasury $31,000,000 of the debenture shares and cash. Halted in the scheme to dissolve, the Jersey company now proposed to use $26,000,000 of the debenture shares to retire that amount of the $29,500,000 of its common stock, and proceedings, according to the statute, are under way to decrease the common stock to $3,500,000. Accomplished, this would leave $5,000,000 in debenture shares and cash to secure the unredeemed bonds and preferred stock. The complainants, owners of $40,000 of the bonds, object, contending that the debenture shares are, as after-acquired property, subject to the lien of the bonded indebtedness, and that the intended use would be a dissipation of their security, to which the Jersey company in substance replies that the security will be equal to what it was when the bonds were issued, that it is ample that the complainants ought to be contented—an appeal to the complacent, but not an answer to the issue tendered.

It is debatable whether the Jersey company had the right to sell its assets in bulk and retire from business, in view of the covenant contained in the trust deed that "it will at all times do all things necessary to preserve its corporate existence, and will actively conduct and carry on the business for which it was incorporated," notwithstanding the provisions of its charter and a clause in the trust deed that "until default as hereinafter defined, the powder company shall at all times have control of all of its property, and the right to use, sell, or otherwise deal with and in the same as it may see fit, and may dispose of all profits and income thereof, including income of the securities held by the trustee in the shape of dividends or otherwise." This question, however, is not raised and under the frame of the bill the exchange by the Jersey company of one class of property for the other is affirmed and the substitution of securities assented to. It is also not in dispute that upon the conversion, the lien of the trust deed upon the newly acquired property was subject to the right reserved to declare dividends, and the distribution of all the surplus by the 200 per cent. dividend to the common stockholders is not challenged. Nor is the use of the securities, to redeem pro tanto the bond issue, seriously criticized,

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2 "* * * debenture bonds are such as are issued without specific security." Matter of Mercantile Properties, Inc., 278 N.Y. 325, 327, 16 N.E.2d 352, 1938. See, also, Dewing, The Financial Policy of Corporations, 4th Ed., 1941, Vol. I, 230–235; Notes, 1928, 28 Col.L.Rev. 360; 1911, 24 Harv.L.Rev. 389.

as it well might be, but what the complainants protest against is the further abstraction of securities from the fund created and pledged to secure their debt and their absorption by stockholders, in liquidation of a subordinate liability—an effort which finds no support in principle or authority, and so inherently wrong as to require only a recital to manifest its illegality. Ikelheimer v. Cons. Tobacco Co., N.J., 59 A. 363; Fidelity Trust Co. v. Hoboken & Manhattan R. R. Co., 71 N.J.Eq. 14, 63 A. 273; Watt v. Hestonville, M. & F. P. R. R. Co., 1 Brew., Pa., 418.

Acknowledging that the scheme to reach $26,000,000 of $29,500,000 of assets, by converting it into surplus through a reduction of the par value of the Jersey company's 350,000 shares of common stock from $100 to $10, thus decreasing its authorized capital from $35,000,000 to $3,500,000, ignores the bondholders' lien upon the entire capital, the defendant argues with much earnestness that inasmuch as the ratio of assets to bonds at the time they were issued was 2½ to 1, and that the remnants under the proposed plan will leave the ratio of $5 of security to every dollar of bond, plus the lien of the trust deed upon the property transferred, the complainants will suffer no injury and have no cause for complaint. This falsely assumes the power to convert capital into surplus for stock dividend purposes, and the right of the debtor to dictate what of his securities the creditor may retain and what of them may be confiscated. But if the Jersey company's assurance that the bonds will be paid at maturity and the interest in the meantime, and that the security is adequate, even giltedge, be accepted, as facts, it is still clear that the bondholders will be injuriously imposed upon and their property impaired. Industrial securities, unlike investment in ordinary bond and mortgage on land, have a legitimate speculative value depending on the success or failure of the enterprise and reflected by daily quotations on the Exchange. No better illustration can be had than the rise in market value from $85 to $102, of these very bonds, the moment the reorganization was announced and it became known that back of the bonds were $200,000,000 instead of $37,-500,000. And that such an event was probable and contemplated by the New Jersey company is evinced by the stipulation in the trust deed that at any time before maturity the bonds were redeemable at $110. Of this prospect, obviously the bondholders cannot be deprived. But, aside from the speculative feature, it is the province of the bondholders to retain all that has been pledged to secure their debt, and until they are paid the debtor has no choice. Who can tell what the Delaware company's debenture shares will be worth henceforth and until maturity in 1936? Surely the complainant bondholders are not obliged to take the risk.

The provision in the trust deed requiring a demand by 25 per cent. in value of the bondholders to move the trustee to action restricts collection or foreclosure proceedings, but is not a limitation upon the inherent rights of bondholders to protect their interests. Chicago, etc., R. R. Co. v. Fosdick, 106 U.S. 47, 27 L.Ed. 47; Carter v. Fortney, C.C., 170 F. 463; Guaranty Trust Co. v. Green Cove R. R., 139 U.S. 137, 11 S.Ct. 512, 35 L.Ed. 116; Mack v. American, etc., Co., 79 N.J.L. 109, 74 A. 263; Schultze v. Van Doren, 64 N.J.Eq. 465, 53 A. 815, af-

firmed 65 N.J.Eq. 764, 55 A. 1133; Reinhardt v. Interstate Telephone Co., 71 N.J.Eq. 70, 63 A. 1097.

An injunction will issue restraining the distribution of the assets to the stockholders. With the proposed reduction of capital stock, the secondary purpose of which is to reduce corporation taxes, the complainants have no concern, and the ad interim restraint in this respect will be dissolved. The complainants are entitled to costs.

2. REMEDIES

FLEMING v. FAIRMONT & MANNINGTON RAILROAD CO.

Supreme Court of Appeals of West Virginia, 1913.
72 W.Va. 835, 79 S.E. 826, 49 L.R.A.,N.S., 155.

Error to Circuit Court, Marion County.

Action by A. S. Fleming against the Fairmont & Mannington Railroad Company and others. Judgment for defendants, and plaintiff brings error.

LYNCH, J. The plaintiff brought his action before a justice and recovered judgment on overdue coupons detached from defendant's bonds, secured by mortgage on all its property then owned and thereafter acquired by it. On appeal the intermediate court dismissed the action; and upon further appeal the circuit court affirmed the latter judgment. Hence this writ of error.

It is agreed that, before action, the coupons were due, and, although properly presented for payment, were unpaid. The plaintiff was therefore entitled to judgment and execution thereon, unless inhibited by some provision of the mortgage securing the bonds and coupons. The defendant cites sections 1 and 2 of article 5 of the mortgage as authority denying plaintiff's right to recover on the coupons.

But from these sections no intention appears, expressly or by implication, to preclude plaintiff from relief by the form of action adopted by him. To have this effect, the restriction must be clear and reasonably free from doubt. "The common-law right to sue upon a bond is not affected by the remedies provided in the mortgage given simultaneously and for the better securing of the bond unless the provisions of the mortgage exclude this right in express terms or by necessary implication." For "the right to sue upon a written obligation admitted to be valid is of too high a character to be taken away by implication, especially if drawn from an instrument other than that which is given in direct and positive acknowledgment of the debt." Manning v. Railroad Co., C.C., 29 F. 838; Nute v. Insurance Co., 72 Mass. 174, 181, 6 Gray 174, 181; Kimber v. Gunnell, 126 F. 137, 61 C.C.A. 203; Jones on Corp. Bonds, § 340.

The purport of the whole article relied upon by defendant is to define the rights, duties, and remedies of the trustee and bondholders, should the mortgagor default in the payment of the bonds or interest. It provides what course each shall pursue, for enforcement of the lien, when such default occurs. It provides: First, that, should the mortgagor refuse or fail after demand to perform any of the covenants

and stipulations in the mortgage or the bonds secured thereby, the trustee shall, upon the request of the holders of one-third in amount of the bonds and adequate security against costs, expenses, and liabilities, enter upon the mortgaged property, manage and operate it, collect the receipts, and apply the income, after deducting current expenses and costs, to the principal and interest of the bonds as the same become due; or, second, upon like default, request, and security, he shall sell the property and make application of the proceeds in the manner stated; or, third, upon like default, request, and security, he shall proceed to protect and enforce the rights of the bondholders under the mortgage by suits in law or equity. The instrument fully states the manner in which the trustee shall perform the duties so prescribed and then concludes immediately thereafter with the general statement: "It being understood, and it is hereby expressly declared, that the rights of entry and sale hereinbefore granted are intended as cumulative remedies allowed by law, and that the same shall not be deemed in any manner whatever to deprive the trustee or the beneficiaries under this trust of any legal or equitable remedy, by judicial proceedings, consistent with the provisions of these presents, according to the true intent and meaning thereof."

The sole and manifest purpose of these provisions is to secure the subject-matter of the lien against illegal invasion, the effect of which would be its impairment as ample security for payment of the mortgagor's bonded indebtedness; and, in order to remove any possible excuse for misunderstanding of its terms and to afford reasonable assurance of the proper interpretation, the concluding clause in express terms declares the absence of any intent to deprive the bondholders of any existing legal or equitable remedies not inconsistent with the purposes, the subservance of which the section in its entirety comprehends. * * *

The termination of plaintiff's action in a judgment, even when followed by execution, cannot "affect, disturb, or prejudice" the lien of the mortgage. The property therein embraced is immune from levy. It cannot be disturbed. Nor can the operation of defendant's railroad be impeded as a result of any judgment obtained in this action, or any proceeding thereafter to enforce payment of the judgment, except in the manner permitted by the mortgage. 1 Elliott on Railroads, §§ 486, 509; 3 Cook on Corp., 6th Ed., §§ 770, 772; 5 Thomp. on Corp., 1st Ed., § 6124; Jones on Corp. Bonds, § 340; Hospital v. Library Co., 189 Pa. 269, 42 A. 183; Com. v. Railroad Co., 122 Pa. 306, 15 A. 448, 1 L.R.A. 225; Trust Co. v. Steel Co., 33 Misc. 484, 68 N.Y.S. 915; Kimber v. Gunnell, 126 F. 137, 61 C.C.A. 203. The creditor does not thereby acquire a lien on defendant's property prior to the mortgage. When suing at law upon an overdue coupon and proceeding against the railroad company, the bondholder, as shown by the authorities cited, stands upon the same plane as any other creditor; and execution on a judgment in his favor can be levied only on property actually owned by the company and not upon that which has been conveyed to trustees by a mortgage or deed of trust duly executed and recorded. When it becomes necessary for him to reach the property held by the trustee, he must proceed against him not for his

own benefit but as a bondholder and on behalf of all the bondholders as a class. What may be realized by such proceeding belongs to the whole class and must be distributed among its members pro rata. 5 Thomp. on Corp., 1st Ed., § 6124; Com. v. Railroad Co., supra. Nevertheless, nothing otherwise prohibiting, he is entitled to judgment and execution thereon. If property belonging to the defendant other than that already bound by the lien of the mortgage is available for levy under execution, he may levy upon it, but not otherwise. Carr v. Le Fevre, 27 Pa. 413; Railroad Co. v. Johnson, 54 Pa. 127; Com. v. Railroad Co., supra; Bradley v. Railroad Co., 36 Pa. 141; Trust Co. v. Steel Co., supra; Thomp. on Corp., 1st Ed., §§ 6124, 6125; Jones on Corp. Bonds, § 340. The fact that a prospective judgment against a defendant in an action at law will be worthless is no defense to the action. * * *

* * * judgment * * * for the amount of the coupons sued on, with interest thereon, and costs. Reversed and rendered.[3]

NEW ORLEANS PACIFIC RAILWAY CO. et al. v. PARKER et al.

Supreme Court of the United States, 1891.
143 U.S. 42, 12 S.Ct. 364, 36 L.Ed. 66.

[Plaintiff, Parker, brought a bill in equity to foreclose a mortgage given by the New Orleans, Baton Rouge & Vicksburg Railroad Company in 1870. The mortgage provided that it covered all property "which is now owned or which shall hereafter be acquired by the said company and which shall be appurtenant to or necessary or used for the operation of said main line of railroad or any of said branches." The mortgage provided that the bondholders might institute foreclosure proceedings.

In 1871, certain lands were granted to the railroad by Congress. The railroad built its line over other lands, and by Act of Congress, the withdrawal of the land grant was ordered.

In 1881, the railroad transferred all its right, title and interest in these lands to the New Orleans, Pacific Railway Company, who received patents therefor in 1885 as assignee. In 1883 and 1884, the Pacific Co. mortgaged these lands to secure certain bonds which plaintiff alleges are subsequent to and subordinate to the Baton Rouge mortgage securing payment of the bonds in suit.

Plaintiff claimed the amount of matured coupons on two bonds, and filed suit for himself and all those holding similar bonds. Hamlin, another bondholder under the same mortgage, intervened as plaintiff. Defendants, the Baton Rouge Co., the Pacific Co., and others interposed a demurrer which was overruled. They then filed an answer alleging that Baton Rouge Co.'s charter did not authorize a mortgage on the land grant, nor did the mortgage embrace it, and that legal title thereto remained in the United States until the patents were granted to the Pacific Co. Defendants also filed a cross-bill for a de-

[3] See Note, 1937, 108 A.L.R. 88, on restrictions on individual bondholders' suits; 1927, 27 Col.L.Rev. 443, on the rights and remedies of the bondholder.

cree adjudging that the land grant was not embraced by said mortgage.

Decrees were rendered for plaintiffs, Parker and Hamlin for their claims; the mortgage was held a valid lien on the lands, which were ordered sold; and defendants' cross-bill was dismissed. Defendants appeal.]

MR. JUSTICE BROWN delivered the opinion of the court: * * *

The decrees in this case were also fatally defective in ordering all the lands assumed to be covered by this mortgage to be sold, free from all liens, mortgages and incumbrances, to satisfy a claim of $2,400 in one case and $6,000 in another, without making provision for other bondholders, subsequent mortgagees or other creditors of the road. Assuming for the purposes of this case that, under the peculiar terms of this mortgage, these bondholders had the right to file this bill without calling upon the trustee to act—a point upon which we express no opinion—they had no right to a decree for their exclusive benefit. If a single bondholder has any right at all to institute proceedings, he is bound to act for all standing in a similar position, and not only to permit other bondholders to intervene, but to see that their rights are protected in the final decree. Upon this principle it was held by this court, in Pennock v. Coe, 64 U.S. 117, 23 How. 117, 16 L.Ed. 436, that a bondholder cannot, by getting a judgment at law, be permitted to sell a portion of the property devoted to the common security, as this would disturb the pro rata distribution among the bondholders to which they are equitably entitled. "These bondholders," said Mr. Justice Nelson, "have a common interest in this security, and are all equally entitled to the benefit of it; and in case of a deficiency of the fund to satisfy the whole of the debt, in equity, a distribution is made among the holders pro rata * * * To permit, therefore, one of the bondholders under the second mortgage to proceed at law in the collection of his debt upon execution would not only disturb the pro rata distribution in case of a deficiency, and give him an inequitable preference over his associates, but also have the effect to prejudice the superior quality of the bondholders under the first mortgage, which possesses the prior lien." Jones, Railroad Securities, §§ 392, 393, 434; Fish v. New York Water Proof Paper Co., 29 N.J.Eq. 16; Martin v. Mobile & O. R. Co., 7 Bush, Ky., 116. * * *

The decrees of the court below must be reversed and the case remanded with instructions to dismiss the bills of Parker and Hamlin, and for further proceedings in conformity with this opinion.[4]

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[4] *Cf.* N.Y.Real Property Law, art. 4-A, § 130-e.

On equity's power to compel a trustee to purchase at the foreclosure sale for the benefit of all bondholders, and bid in all bonds in payment of the purchase price, even though such action is not authorized by the bondholders, see Breidenbach, Right of a Trustee to Bid at Foreclosure Sale, 1937, 21 Marq.L.Rev. 61; Katz, The Protection of Minority Bondholders in Foreclosures and Receiverships, 1936, 3 U. of Chi.L.Rev. 517, 548–555; Notes, 1934, 28 Ill.L.Rev. 929, 29 Ill.L.Rev. 218; 1936, 49 Harv.L.Rev. 487.

SEIBERT v. MINNEAPOLIS & ST. LOUIS RY. CO. et al. (GRIGGS, Intervener).

Supreme Court of Minnesota, 1893.
52 Minn. 148, 53 N.W. 1134, 20 L.R.A. 535, 38 Am.St.Rep. 530.

Appeal by intervener, F. H. Griggs, from an order sustaining the demurrer of defendants, Central Trust Company of New York, Fidelity Insurance Trust & Safe-Deposit Company and Farmers' Loan & Trust Company.

[The Minneapolis & St. Louis Railway Co. mortgaged its railroad to the Central Trust Co. as trustee to secure certain bonds. Plaintiff, Seibert, was substituted trustee, and brought this action to foreclose the mortgage.

There were several prior mortgages on the railroad to secure other bonds. Griggs, owner of some of these bonds, intervened, asking that these prior mortgages also be foreclosed. He alleged that there was a provision in the mortgage that: "In case default shall be made in the payment of any of said coupons, or semi-annual interest upon any of the aforesaid bonds * * * and in case such default shall continue for * * * four months *after the said coupons shall have become due and payable,* then and thereupon the principal of all the bonds secured hereby shall become immediately due and payable, * * *."

Farmers' Loan & Trust Co., trustee of these bonds, demurred to Griggs' complaint. The demurrer was sustained, and Griggs appeals. (The other facts are sufficiently stated in the opinion.)]

VANDERBURGH, J. This suit is brought to foreclose a certain mortgage executed by defendant railway company to the Central Trust Company, which has been superseded by the appointment of the plaintiff as trustee in its place. The defendants Farmers' Loan & Trust Company and Central Trust Company are named as trustees in other mortgages executed by the railway company. * * *

Intervener avers that all of his said described coupons from the bonds in this division referred to have been presented for payment at the agency of the said Minneapolis & St. Louis Railway Company in the city of New York, and the payment of the interest therein specified has been demanded, and payment was refused; and all the said coupons have also been presented for payment to the acting treasurer of said Minneapolis & St. Louis Railway Company, at the city of Minneapolis, Minn.; and the payment of the interest specified was demanded, and payment was refused, and default has been made in the payment of all the described coupons from said bonds. It also alleged that, excepting as to the several coupons aforesaid which became due and payable on the 1st day of December, 1891, such default as to the payment of all said coupons has continued for the period of more than four months from the several dates when they severally became due and payable; wherefore intervener avers that the principal of all the bonds secured by said mortgage or deed of trust in the division referred to has become due and payable, and all the bonds secured by

the said mortgage are now due and payable; that by article 9 of said mortgage it is provided

"That it shall be the duty of the trustee, upon proper indemnification against costs and expenses, to execute the power of entry or the power of sale by said mortgage granted, or both, to take appropriate proceedings in equity or at law to enforce the rights of the bondholders, in case of any default made by the mortgagee, upon requisition in writing as thereinafter specified, viz.:

"First. If the default be as to either the interest or the principal of any of the bonds aforesaid, such requisition upon the said trustee shall be by holders of not less than twenty-five per centum of the said bonds then outstanding; and upon such requisition and indemnification it shall be the duty of the trustee to enforce the rights of the bondholders under these presents by entry, sale, or legal proceedings, as it, being advised by counsel learned in the law, shall deem most expedient for the interest of all the holders of the said bonds.

"Second. But it is expressly understood that such duty of the trustee shall be at all times subject to the power hereby declared of a majority in interest of the holders of the said bonds by requisition in writing, signed by such majority, to instruct the said trustee to waive such default: provided, however, that no action of the bondholders in waiving such default shall extend or be taken to affect any subsequent default, or to impair the results arising therefrom.

"And it is hereby further expressly agreed and made binding upon each and every holder of bonds secured hereby that no proceedings at law or in equity shall be taken by any bondholder to foreclose the equity of redemption under this instrument, or to procure a sale of the property covered thereby, independently of the party of the second part, trustee, or its successors in said trust, except after a requisition shall have been made to the said trustee in manner and form as hereinbefore provided, and also until after a refusal of the said trustee to comply with such requisition according to the provisions herein made in respect thereto."

Intervener submits and claims "that the said provisions of article 9 of said last-described mortgage are void, in so far as they attempted to deprive the holder of any of the bonds which may have become due by default in payment of the interest coupons, or the holders of any of the past-due coupons, from enforcing the remedy whereby he might have his lien established upon the mortgaged property without the requisition of the holders of not less than 25 per centum of the said bonds then outstanding; that said provisions are in fact an attempt to oust the jurisdiction of any court to entertain a complaint by, or give relief to, the holders of less than 25 per centum of the outstanding bonds."

The principal question involved in this appeal, therefore, is whether the provisions of article 9, above quoted, restraining proceedings for foreclosure on the part of individual bondholders until after the requisition made upon the trustees by a certain proportion of the bondholders as therein provided, and a refusal by him to comply therewith, is valid and obligatory upon the individual bondholders as respects the enforcement of the security.

We are unable to see why the bondholders, subject to reasonable limitations, may not be bound by stipulations in the mortgage of this character, waiving a default, and providing, subject to the conditions named, for the foreclosure by the trustee exclusively. The interests of the bondholders as a class and the nature of the security are to be considered. "They are agreements which the bondholders are at liberty to make, and there is nothing illegal or contrary to public policy in them." Chicago, D. & V. Railroad Co. v. Fosdick, 106 U.S. 77, 1 S.Ct. 10, 27 L.Ed. 47. Each bondholder enters into contract relations with each and all of his cobondholders. His right to appropriate the security in satisfaction of his bond in such lawful manner as he may choose is modified not only by the express provisions of the mortgage, but by the peculiar nature of the security. Gates v. Railroad Co., 53 Conn. 346, 5 A. 695; Shaw v. Little Rock & Fort Smith Railroad Co., 100 U.S. 612, 25 L.Ed. 757; Canada Southern Railroad Co. v. Gebhard, 109 U.S. 527, 534–537, 3 S.Ct. 363, 27 L.Ed. 1020; Guilford v. Railroad Co., 48 Minn. 560, 51 N.W. 658, 31 Am.St.Rep. 694. The legislature would have had an undoubted right to have incorporated, in the enabling statute authorizing the execution of the mortgage and the issuance of the bonds secured thereby, a provision requiring the mortgage to contain similar stipulations. Howell v. Western Railroad Co., 94 U.S. 463, 466, 24 L.Ed. 254.

It is clear, then, that it would be competent for the bondholders themselves to agree to them. They are to be treated as stricti juris, but nevertheless are to be reasonably construed in view of the nature of the mortgage, which is the common security for all the bondholders, and the purposes to be subserved in making them. There is no doubt that the parties could lawfully provide in the same instrument for a reasonable extension of the time for the commencement of foreclosure proceedings, to be determined at the option of a majority of the bondholders. Nute v. Hamilton Mutual Insurance Co., 6 Gray, Mass., 174. But the waiver of the default provided for in this instance amounts substantially to the same thing. So the mortgage might have been so drawn as to permit foreclosure proceedings to be instituted only after default in the payment of the principal debt or some part of it. The stipulation for the waiver of the default in the payment of interest is in principle no different.

Again, the trustee, as mortgagee, representing the interests of all the bondholders as beneficiaries, is the proper party to institute foreclosure proceedings, but, if he unreasonably neglects or refuses to discharge his duty in the premises, doubtless any bondholder may bring an action to enforce the security for the common benefit. Chicago, D. & V. Railroad Co. v. Fosdick, 106 U.S. 68, 1 S.Ct. 10, 27 L.Ed. 47. Why may not the mortgage in the common interest stipulate the conditions under which this right may be exercised by the bondholders, and, in order to avoid the risk of rash or arbitrary proceedings which might result in great injury to the security, provide that no such proceedings should be instituted by an individual bondholder except upon the refusal of the trustee to obey the requisition of a reasonable number of the bondholders? It is not the intention or effect of such con-

ditions or stipulations to divest the bondholders of their right to judicial remedies, or to oust the courts of their jurisdiction; it is merely the imposition of certain conditions upon themselves in respect to the exercise of that right. And this distinction is well recognized by the courts. Gasser v. Sun Fire Office, 42 Minn. 315, 44 N.W. 252, and cases; Guilford v. Railroad Co., 48 Minn. 560, 51 N.W. 658. The provisions of this mortgage are not, we think, unreasonable or invalid. * * *

Orders affirmed.[5]

CARTER et al. v. FORTNEY et al.

Circuit Court of the United States, N.D. Virginia, 1909. 170 F. 463.

[Plaintiff bondholders of the Merchants Coal Company brought suit for an injunction to restrain defendants, former employees of the corporation, from interfering with the company's mining activities, its officers and employees, from picketing and from preventing others from entering the companies' service, in pursuance of a strike on defendants' part against a wage reduction. A temporary injunction was granted. Defendants interposed a demurrer to the bill, alleging in substance, that plaintiffs are not proper parties to seek this injunction. The demurrer was argued and submitted.]

DAYTON, DISTRICT JUDGE. * * * The demurrer admitting the allegations of the bill to be true justify me in giving them construction liberal to the interests of the complainants without in any manner, in case the demurrer is overruled, prejudicing judgment upon final hearing when the evidence shall disclose to what extent these allegations are sustained by the facts. * * *

The second objection, that bondholders secured by a trust deed cannot maintain suit without alleging the refusal of the trustees to institute the same, is not tenable. * * *

A trust mortgage generally by its own express terms is a tripartite agreement between creditors, debtor, and trustees whereby the creditors as a class loan their money upon certain stipulated terms and conditions to the debtor, who secures these loans upon like terms and conditions by a lien upon designated property. To properly secure this lien, and further to create an agent for both creditors and debtor to secure performance of the mutual terms and conditions agreed upon, inter partes, the property is conveyed to a trustee with express powers to perform these conditions. Under such circumstances it has been

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5 *Accord*, Townsend v. Milaca Motor Company, 194 Minn. 423, 260 N.W. 525, 1935. The Trust Indenture Act, [sec. 316, 15 U.S.C.A. § 77ppp] permits the inclusion in the indenture of a clause authorizing a majority of the bondholders to exercise any duties conferred on the trustee; to waive any past default; or to permit not less than 75% of the bondholders to postpone interest payment for not more than three years from its due date. However, a clause must be included in the indenture, providing that the right of any individual bondholder to receive payment of interest or principal shall not be injured by any provision of the indenture.

See, Israels and Kramer, The Significance of the Income Clause in a Corporate Mortgage, 1930, 30 Col.L.Rev. 488, 498 et seq.; Lester, The Effect of Corporate Mortgage Provisions Conditioning Right of Trustee to Act on Default, 1932, 4 Rocky Mt. L.Rev. 163; Note, Validity of Default Provisions in Trust Mortgages, 1931, 31 Mich. L.Rev. 86; 1937, 32 Ill.L.Rev. 105; 1936, 42 W.Va.L.Q. 250.

well held that individual bondholding creditors thus secured must, before bringing suit themselves, request the trustee to sue touching all matters relating to the obligations inter partes created by the terms of the trust itself, such as the demand for accounting from the trust debtor or the demand for a foreclosure and sale. The reason in such cases is clear; the creditors are by the terms of the trust created a class with equal rights, and the trustee is created an agent for them as such. In many cases it would be distinctly against the interests of the other creditors to allow one or more of their number to institute proceedings for selfish reasons against the property, involving its management and calculated to destroy its credit or value. Such are the cases cited by Judge Ross. But in a case like this, when the bondholding creditor is not seeking to interfere with but to maintain the trust obligations and the trust subject from interference and destruction from outside sources, over which neither bondholder, debtor, nor trustee have any control, I can perceive neither any power, or at least obligation, on the part of the trustee, limited by the terms of his trust, himself to sue without direction from the bondholders or to prevent the bondholders from suing. * * *

The demurrer must be overruled.[6]

THE TRUST INDENTURE ACT OF 1939, 15 U.S.C.A. § 77ppp.

Directions and Waivers by Bondholders; Prohibition of Impairment of Holder's Right to Payment

(a) The indenture to be qualified may contain provisions—

(1) authorizing the holders of not less than a majority in principal amount of the indenture securities at the time outstanding (A) to direct the time, method, and place of conducting any proceeding for any remedy available to such trustee, or exercising any trust or power conferred upon such trustee, under such indenture, or (B) on behalf of the holders of all such indenture securities, to consent to the waiver of any past default and its consequences; or

(2) authorizing the holders of not less than 75 per centum in principal amount of the indenture securities at the time outstanding to consent on behalf of the holders of all such indenture securities to the postponement of any interest payment for a period not exceeding three years from its due date.

For the purposes of this subsection and paragraph (3) of subsection (d) of section 77ooo, in determining whether the holders of the required principal amount of indenture securities have concurred in any such direction or consent, indenture securities owned by any obligor upon the indenture securities, or by any person directly or indirectly controlling or controlled by or under direct or indirect common control with any such obligor, shall be disregarded except that for the purposes of determining whether the indenture trustee shall be protected in relying on any such direction or consent, only indenture securities which such trustee knows are so owned shall be so disregarded.

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6 Preliminary injunction granted, 172 F. 722, C.C.N.D.W.Va. 1909; after trial, permanent injunction granted; aff'd, 203 F. 454, C.C.A. 1913.

(b) The indenture to be qualified shall provide that, notwithstanding any other provision thereof, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder, except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a), and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien. May 27, 1933, c. 38, Title III, § 316, as added Aug. 3, 1939, c. 411, 53 Stat. 1172.

3. RESPONSIBILITIES TO EACH OTHER

HACKETTSTOWN NATIONAL BANK v. D. G. YUENGLING BREWING CO.

Circuit Court of Appeals of the United States, Second Circuit, 1896. 74 F. 110.

In error to the Circuit Court of the United States for the Southern District of New York.

This was an action at law by the Hackettstown National Bank of Hackettstown, New Jersey, against the D. G. Yuengling Brewing Co., upon certain bonds issued by that corporation. The circuit court directed a verdict for defendant, and to review the judgment entered thereon, plaintiff sued out this writ of error.

WALLACE, CIRCUIT JUDGE. Error is assigned of the ruling of the trial judge in directing the jury to find a verdict for the defendant.

The action was brought to recover the principal and interest of certain second mortgage bonds owned by the plaintiff, part of an issue of $1,000,000, created by the defendant, and secured by a trust deed upon all its real and personal property. The bonds bear date December 31, 1893, and are payable, the principal July 1, 1908, and the interest semi-annually on the 1st days of January and July in each year, subject to conditions indorsed upon the bonds, of which the following are material:

"(4) The principal moneys hereby secured shall become due and payable forthwith * * * if the company makes default for a period of three calendar months in the payment of any interest hereby secured thereby, and the bearer or registered holder hereof, as the case may be, before the interest so in arrear is paid, by notice in writing to the company, calls in the principal moneys hereby secured."

"(11) Subject to the conditions of the trust deed hereinafter mentioned, the holders of three-fourths in the value of the outstanding bonds of this series may sanction any agreement of the company for any modification or alteration of the rights of the bondholders of this

series as a class, including the release of any property charged thereby, and any postponement of the time for the payment of any moneys secured thereby, and any increase or reduction of the rate of interest; and an agreement so sanctioned shall be binding upon all bondholders of this series, and notice of any action thus taken shall be given to each bondholder, and each bondholder shall be bound thereupon to produce his bond to the company, and to permit a note of such modification to be placed thereon."

The mortgage provides that the security shall be enforceable, if, after default shall have been made in the payment of the principal of the bonds, and continued for six months or in payment of interest, and continued for three months, the holders of a majority of the bonds shall, by notice to the trustee, elect and declare the principal and interest payable. It also contains provisions for meetings of the bondholders, to be called at the request of the company, the trustee, or by holders of one-third of the amount of outstanding bonds; provides that such meetings shall have power, by extraordinary resolution, "to sanction any modification or compromise of the rights of the bondholders against the company or against its property, whether such rights shall arise under the bonds or trust deed, or otherwise," and provides that such extraordinary resolution may be passed by the vote of holders of a majority of the outstanding bonds.

Evidence was introduced upon the trial tending to establish the following facts: Default was made in the payment of the interest coupons maturing January 1, 1894, and again in the payment of the interest coupons maturing July 1, 1894, and no part of the interest on these coupons was ever paid. After such default had continued for three months, the plaintiff, by notice in writing to the company, demanded the payment of the principal of the bonds as well as the interest. Shortly after the maturing of the second coupons, and when it was supposed that they would not be paid, and that by reason of the continued default the principal sum of the bonds might be declared payable by the bondholders or the trustee, David G. Yuengling, who was the principal stockholder of the corporation, entered into an agreement with John F. Betz, which had for its object the purchase of a sufficient number of the bonds to enable Betz, in conjunction with Yuengling, and some of his relatives and friends, who were likewise bondholders, to control three-fourths in value of the outstanding bonds of the series. The agreement provided that Betz should purchase a sufficient amount to control proceedings in foreclosure; that, if any of the coupons maturing subsequently to January 1, 1895, should be in default, Yuengling would personally pay such coupons on all of the bonds purchased by Betz; that Betz should hold all bonds purchased by him subject to the right of Yuengling, at any time before their maturity, to demand and receive an absolute transfer thereof, together with all unpaid interest coupons, upon the repayment of all moneys advanced by Betz, with interest at 6 per cent.; and that Betz would not transfer or dispose of any of the bonds thus to be purchased in any other manner until the option above mentioned should have expired. Pursuant to this agreement, Betz commenced and continued to purchase bonds until in De-

cember, 1894, he had acquired them to the amount of $594,600. December 1, 1894, Betz, with the holders of other bonds, which, with his, were of the amount of $728,100, executed an instrument which, in substance, after reciting the inability of the company to pay its coupons, and that it would be for the best interests of the company and its bondholders to postpone the time of payment of all coupons attached to the bonds, whether past due or to become due on or before July 1, 1896, evidenced their request and consent that the company and the trustee in the deed of trust execute an agreement providing for postponing until January 1, 1900, the time for the payment of all coupons attached to the bonds of the series, whether past due or to become due and payable on or before July 1, 1896. This agreement is signed by Mr. Betz for $594,600 of the bonds, by Yuengling for $18,800, by the estate of Yuengling's father for $10,000, and by the wife of Yuengling for $70,700. Thereafter an agreement such as was authorized by the consent was executed between the company and the trustee. December 29, 1894, a majority of bondholders composed of the same persons who executed the consent, at a meeting called pursuant to the provisions of the trust deed, voted an extraordinary resolution suspending the fourth condition of the bonds until January 1, 1900. No evidence was introduced tending to show that there had been any material change in the circumstances of the company since the creation of the bonds, or that the ultimate security of the bondholders would be promoted by waiving the default in the payment of interest and deferring the enforcement of the security. There was no consultation with the minority stockholders prior to the execution of the consent. The ruling of the trial judge proceeded upon the theory that the consent of the holders of three-fourths in value of the outstanding bonds operated to extend the time of payment of the interest and principal of the bonds, and he refused to submit to the jury the question whether the consent was made bona fide by the bondholders who were parties thereto.

We cannot doubt that a consent to postpone the payment of the demands of the minority bondholders, made collusively by majority bondholders for the purpose of defeating the remedy of the minority, and not in the exercise of an honest discretion in the general interest, is not a consent within the meaning of the eleventh condition; or that a vote at a meeting of bondholders, sanctioning a modification of the rights of the bondholders, passed by a corrupt majority for the purpose of effectuating such a collusive consent, is not within the power contemplated by the provision in the trust deed.

Community of interest, whether in the case of partners or security holders, creates mutual obligation, and imposes upon all persons occupying that position the duty of acting in the utmost good faith towards the interests of their associates. Upon this principle it was declared in Jackson v. Ludeling, 21 Wall. 617, 22 L.Ed. 492, that a holder of certain bonds, part of a series secured by a corporate mortgage, had no right to employ them as an instrument by which he could make an illegitimate profit out of the mortgaged property at the expense of the other bondholders. The court used this language:

"When two or more persons have a common interest in a security, equity will not allow one to appropriate it exclusively to himself, or to impair its worth to others. Community of interest involves mutual obligation. Admitting, then, that Gordon had a right to make use of the mortgage to enforce the payment of the bonds which he held, he had no right so to use it as to obtain an advantage for himself over the other bondholders. He had no right to employ it as an instrument by which he might become the owner of the property mortgaged at the lowest possible price at which it could be obtained, leaving the bonds held by his associate holders unpaid. His duty, if he used it at all, was to make it productive of the most that could be obtained for all who were interested in it; and if he sought to make a profit at the expense of those whose rights in it were the same as his own, he was unfaithful to the relation he assumed, and was guilty of fraud."

The law would not tolerate any agreement made in advance by such associates intended to permit the relaxation of a duty which is enjoined by good morals and the highest expediency, and every presumption is against the supposition that contracting parties intend a compact which the law condemns. Agreements between bondholders lodging in the majority in interest the power of control over the common fund contemplate that those having the largest interest in its conservation will be the most zealous. They are intended to minimize the power of a factious minority to thwart the general good. But every delegation of power implies that it will be honestly exercised. In discussing a reorganization agreement, by the terms of which the bondholders covenanted that a majority of the holders of the outstanding bonds might purchase the mortgaged premises at foreclosure, and that the new company should be organized upon such terms and in such manner as the majority holders should direct, the supreme court said:

"The agreement, though unusual, was a reasonable one. While it prevented a small minority of the bondholders from forcing unreasonable and inequitable concessions from the majority, it did not empower that majority to crush out the rights of the minority or to put them at any disadvantage. It authorized only such arrangements as would inure equally to the benefit alike of the majority and the minority." Sage v. Central Railroad Co. of Iowa, 99 U.S. 334, 25 L.Ed. 394.

Powers in trust deeds, conferred on a majority of bondholders, to bind the minority, have been the subject of consideration in several cases in the English courts, and were given full effect. In these cases the power was contained in a provision, similar to that in the present trust deed, by which the bondholders at a meeting, by extraordinary resolution, were authorized to sanction any modification or compromise of the rights of the bondholders against the company or its property. It was assumed by the court in all of these cases that the power was only called into existence when required by the exigencies of the situation, and when exercised must be exercised in good faith. Mercantile Investment & General Trust Co. v. International Co. of Mexico [1893] 1 Ch. 484, note; Mercantile Investment & General Trust Co. v. River Plate Co. [1894] 1 Ch. 596; Follit v. Eddystone Granite Quarries [1892] 3 Ch. 75; Sneath v. Gold Co. [1893] 1 Ch. 477.

Applying these conclusions to the facts of the present case, it must be held that, if the consent was made and the resolution passed by the majority of bondholders, not in the common interest of all, but in the interest of Yuengling, with a view of enabling him, by deferring for five years the payment of interest, to compel the minority bondholders to sell their bonds on such terms as he might dictate, it was a corrupt and unwarranted exercise of the power of the majority.

The fact that Betz purchased the bonds in the interest of the principal stockholder of the company, and for the purpose of controlling the rights of the minority bondholders, is important only as it serves to throw light upon the bona fides of the consent and vote. He had a right to make the purchase, and, having acquired title to the bonds, succeeded to all the rights of an ordinary bondholder. Yuengling himself might have purchased them, and by doing so would have acquired the same rights. Any purchaser of the bonds was entitled to use them for the purpose of effectuating an honest consent to postpone payments due. But no purchaser could acquire any right to employ them as instruments in a conspiracy to defraud the minority bondholders.

We think the evidence upon the trial presented a question of fact for the determination of the jury, and that the trial judge erred in taking from their consideration the question of the bona fides of the consent and vote.

In conclusion it is proper to say that, inasmuch as all the property of the company is included in the trust deed securing the bonds, the plaintiff's remedy by an action at law would seem to be of little value. He would not be permitted to enforce any lien by execution to the embarrassment of the other bondholders. Pennock v. Coe, 23 How. 117, 16 L.Ed. 436; Fish v. Paper Co., 29 N.J.Eq. 16; Railroad Co. v. Woelpper, 64 Pa.St. 366; Bowen v. Railroad Co., L.R. 3 Eq. 541. The judgment is reversed.[7]

C. THE PROPERTY

NOTE

The problems which arise in considering the property covered or to be covered by a corporate mortgage are indeed manifold. They can, however, be grouped into a few helpful categories. The most important problems are those involving identification (i. e. description), time (i. e., after-acquired property), interest (i. e. lessee, conditional vendee, etc.) and quality (i. e., real estate, tangible personalty or choses in action).

Most corporate mortgages do not attempt to convey specific items of real or personal property owned by the mortgagor. Rather do they mortgage all of the assets of the corporation then or thereafter owned, whether real or personal, tangible or intangible. * * *

* * * In view of the size of the average corporation that issues a corporate mortgage, in view of the variegated types of property owned by such a corporation and subjected to the mortgage, in view of the generality of the words of description, and in view of the manner in which attack has been made, the questions presented

[7] See Trust Indenture Act of 1939, § 316, 15 U.S.C.A. § 77 ppp.
See, also, Notes, 1937, 110 A.L.R. 1339; 1939, 38 Mich.L.Rev. 63; 1937, 46 Yale L.J. 1041.

have been legion. * * * [Some of those questions are:] What is the effect of the property to be covered being real estate or personal property? Is it real estate because attached to land or personal property even though attached to land? Does intention to remove property affect its characteristics? Is all of the property mortgaged or merely all of the property used in the pursuit of the corporate business, that is to say, all that property which goes to make the corporation a going concern? Is the property of such a character as to be capable of being mortgaged? May non-existent, "not presently contemplated" or future-acquired property be presently mortgaged? What are the rights of third persons in and to the mortgaged property? McClelland and Fisher, The Law of Corporate Mortgage Bond Issues, Callaghan and Company, 1937, p. 237.

1. AFTER-ACQUIRED PROPERTY CLAUSE

GUARANTY TRUST CO. OF NEW YORK v. NEW YORK & QUEENS COUNTY RY. CO. et al.

Court of Appeals of New York, 1930. 253 N.Y. 190, 170 N.E. 887.

[Appeal from a judgment of the Appellate Division of the Supreme Court in the second judicial department, modifying and affirming a judgment in favor of plaintiff entered upon a decision of the court on trial at Special Term.]

CARDOZO, C. J. The action is one for the foreclosure of a mortgage given in 1892 by the Steinway Railway Company to a trustee for bondholders.

The mortgagor owned and operated a street railroad in Long Island City, and the subject-matter of the mortgage was the road so owned and operated, its rolling stock and equipment, and any after-acquired property necessary or convenient for use in connection therewith.

The defendant New York & Queens County Railway Company was incorporated in 1896 to acquire by merger the Steinway line as well as other lines in neighboring communities, i. e., in Newtown, Flushing, and College Point.

Having purchased the entire capital stock of the Steinway Railway Company, it filed a certificate of merger under section 58 of the Stock Corporation Law then in force (Laws 1896, c. 932; Consol.Laws, c. 59), with the result that it became the owner of the franchise and property of the corporation so merged. It did not, however, either by covenant or by statute, assume the obligations or liabilities of the merged corporation, nor was it answerable therefor. Irvine v. New York Edison Co., 207 N.Y. 425, 101 N.E. 358, Ann.Cas.1914C, 441; Syracuse Lighting Co. v. Maryland Cas. Co., 226 N.Y. 25, 122 N.E. 723.

The shares of the Newtown Railway Company which operated a line in Newtown, the shares of the Riker Avenue & Sanford's Point Company, and the shares of the Flushing & College Point Company, as well as the property and franchises of the Long Island & Newtown Railroad Company, were acquired at or about the same time.

The New York & Queens County Railway thereupon executed its first consolidated mortgage to a trustee, subject to the underlying

mortgages on the constituent lines, the new mortgage covering the property then owned by the mortgagor or thereafter to be acquired.

The present controversy is one between the trustee of the Steinway mortgage on the one side, and on the other side the maker and the trustee of the consolidated mortgage, the former contending that certain after-acquired properties are subject to the lien of the Steinway mortgage, and the others that they are free from that lien and subject only to the lien of the consolidated mortgage. The chief properties so acquired are the Purvis Street substation, the Woodside car barns and contiguous tracks, the Borden Avenue office building, and rolling stock, tools, supplies, and miscellaneous equipment. * * *

A mortgage of property to be acquired in the future is not a present lien at law. Rochester Distilling Co. v. Rasey, 142 N.Y. 570, 37 N.E. 632, 40 Am.St.Rep. 635. It is, however, equivalent to a covenant to give a lien, and as such, when the property comes into existence, may be specifically enforced in equity. Kribbs v. Alford, 120 N.Y. 519, 24 N.E. 811. In the absence of intervening equities forbidding such a use, the property, when acquired, is deemed to feed the mortgage, as if in existence at the beginning. Holroyd v. Marshall, 10 H.L.Cas. 191; Zartman v. First Nat. Bank of Waterloo, 189 N.Y. 267, 82 N.E. 127, 12 L.R.A.,N.S., 1083. There is need to distinguish, however, between the enforcement of the covenant in respect of property thereafter acquired by the mortgagor itself, and property thereafter acquired by a successor or a purchaser. Property thereafter acquired by the mortgagor itself will be subject to the mortgage, if within the description of the covenant, however, alien it may be in quality or function to the property presently subjected to the lien. People's Trust Co. v. Schenck, 195 N.Y. 398, 88 N.E. 647, 133 Am.St.Rep. 807; Ithaca Trust Co. v. Ithaca Traction Corp., 248 N.Y. 322, 162 N.E. 93. It is otherwise in respect of purchasers, and even at times successors. To spread the lien of the mortgage to property acquired by these, there must be an independent ground of duty. This may have its origin in a statute or in a covenant of assumption or in the principles of estoppel or accession, or in some other kindred equity. Trust Co. of America v. City of Rhinelander, Wis., C.C., 182 F. 64, 69; Metropolitan Trust Co. of City of New York v. Chicago & E. I. R. Co., C.C.A., 253 F. 868, certiorari denied 248 U.S. 586, 39 S.Ct. 184, 63 L.Ed. 434. In the case at hand the covenant as to acquisitions is sweeping in its terms, embracing anything "necessary or convenient" for the operation of the road. By its terms also it is to apply to such property when acquired by the mortgagor's "successors" as well as by the mortgagor itself. The problem to be solved is the effect to be given to a covenant so phrased in its application to a railroad succeeding through merger to the franchise of another.

At the outset there is need to consider the meaning of the term "successors." A covenant by a corporation for itself and "its successors" is like a covenant by a natural person for himself, "his executors and administrators." It adds nothing of substance, for it is the expression of an obligation that if not stated would be implied. Matter of Buccini v. Paterno Const. Co., 253 N.Y. 256, 170 N.E. 910;

Kernochan v. Murray, 111 N.Y. 306, 308, 18 N.E. 868, 2 L.R.A. 183, 7 Am.St.Rep. 744; Chancellor v. Bell, 45 N.J.Eq. 538, 541, 17 A. 684; Overseers of Poor of City of Boston v. Sears, 22 Pick., Mass., 122, 126; Cumberland Bldg. & Loan Ass'n v. Aramingo M. E. Church, 13 Phila., Pa., 171, 172; 8 Halsbury Laws of England, pp. 371, 372. In like manner, a covenant by a corporation extending the lien of a mortgage to property thereafter acquired by its "successors" is not an attempt to impose the continuing burden of the covenant in respect of future acquisitions upon a new corporation that is merely a purchaser. It is directed to future acquisitions by those successor corporations that preserve or continue the corporate persona (Mississippi Valley Trust Co. v. Southern Trust Co., C.C.A., 261 F. 765), much as the heir in the Roman law continued the persona of the ancestor (Holmes, The Common Law, p. 343), and in our own system the executor continues for the most part as universal successor the persona of a testator (Holmes, The Common Law, pp. 344, 345, 350; Holmes, Executors, 9 Harv.L. Rev. 42; Collected Legal Papers, pp. 141, 143; Holdsworth, History of English Law, vol. 3, pp. 573, 583). How far the covenant is effective even then as to land or other property subsequently acquired must depend upon the statutes that regulate dissolution or succession.

At the present time in New York a possessor corporation, i. e., one which merges another through the purchase of its shares of stock, "shall be deemed to have assumed all the liabilities and obligations of the merged corporation and shall be, liable in the same manner as if it had itself incurred such liabilities and obligations." Stock Corporation Law, § 85, subd. 2. The same assumption of obligations and liabilities results where there has been a consolidation of two or more corporations as distinguished from a merger. Sections 86, 90. But in 1896, at the time of the absorption of the Steinway line, the consequences flowing from merger were sharply differentiated from those flowing from consolidation. The subject was fully considered in Irvine v. New York Edison Co., supra. The merged corporation was not dissolved, but continued to exist in so far as its existence was necessary for the protection of its creditors. Its property was subject at their pursuit to execution or sequestration in appropriate proceedings, equitable or legal. On the other hand, the new or possessor corporation was not charged with any duty to the creditors except to the extent of holding the property thus acquired in subjection to their claims. It did not gather unto itself and thereafter embody and continue an existing corporate life. It was not bound by the covenants of the merged corporation, nor did it assume them as its own. It was not in the proper sense of the term a successor, but rather an assignee or a purchaser. All this was settled law. If in the case at hand the mortgagor's covenant is enforceable against the merging corporation in respect of property acquired after the merger, it must be by force of some principle of estoppel or of accession, or some other kindred equity. It cannot be by force of any duty of assumption, contractual or statutory.

An attempt is made to relate the obligation to the principle of estoppel. * * *

* * * What has been written is no denial that the new owner will be charged if the circumstances of the transaction are sufficient to

bind him by an estoppel (that is, an estoppel by deed, for there is clearly none in pais), just as he may be bound in other circumstances by a covenant of assumption. Foley and Pogue After-Acquired Property under Conflicting Corporate Indentures, 13 Minn.L.Rev. 94, 95. What is meant is merely this: That the acceptance of a deed subject to such a mortgage of record does not avail without more to give rise to the estoppel, for the mortgage to that extent is invalid and inoperative. The buyer takes the land cum onere in the sense that he must carry out the covenant as to after-acquired property in so far as it was already specifically enforceable against the seller by force of acquisitions prior to the purchase. He does not take it cum onere in the sense that he must carry out the covenant in respect of acquisitions, not within the principle of accession, made thereafter by himself. The distinction is clearly marked in Ithaca Trust Co. v. Ithaca Traction Corp., supra, where a separate power house acquired by a reorganized corporation was held to be free from the lien of an underlying mortgage, though power contracts previously acquired were part of the security. If Citizens' Savings & Trust Co. v. Cincinnati & Dayton Traction Co., 106 Ohio St. 577, 140 N.E. 380, may seem to involve a holding to the contrary, we are to remember that under the statutes of Ohio governing the consolidation of corporations (Ohio General Code, § 9038), "debts, liabilities, and duties of either company, thenceforth shall attach to the new company, and be enforced against it to the same extent as if such debts, liabilities, and duties had been contracted by it." 106 Ohio St. at page 597, 140 N.E. 380, 386, and cf. Foley and Pogue, 13 Minn.L.Rev. 81, 91. The case, therefore, was one of assumption of the mortgage and its covenants by virtue of a statutory duty (cf. Pullman's Palace Car Co. v. Missouri Pac. Co., 115 U.S. 587, 594, 595, 6 S.Ct. 194, 29 L.Ed. 499), and not a case of such assumption through the operation of estoppel. True indeed it is that even where the duty has a statutory origin, improvements and extensions must be segregated to the lines to which they are appropriately related, since only thus can conflict be avoided between after-acquired property clauses in underlying mortgages of equal generality; accretions must still be marshaled according to their nature. On the other hand, the range of extension in such circumstances, is spread beyond the limits that confine it when there is no duty of assumption, either contractual or statutory.

If estoppel is inadequate to enlarge the subject-matter of the mortgage, there is yet to be considered whether enlargement can be accomplished by force of the principle of accession. Accession as a source of title is quite distinct from the operation of a covenant for after-acquired property. 13 Minn.L.Rev. at pages 93, 94. Even in the absence of such a covenant the lien of a mortgage upon a railroad will extend to accretions such as fixtures that are physically united with the subject-matter of the mortgage, and to accretions that may be classified as appurtenances, where the bond of union is organic rather than corporeal. Not only that, but the nature of railroad property will cause the principle of accession to be liberally applied, so that things not strictly fixtures, and interests not strictly incorporeal hereditaments, may be brought within the principle as if they were fixtures or ap-

purtenances under a narrow definition. This at least will be assumed, though the assumption has been questioned. 13 Minn.L.Rev. 93, 94. * * *

The principle of accession, however liberally interpreted, cannot bring within the mortgage the power house and the barn. We put aside for the moment the extension of the mortgage to rolling stock, supplies, and miscellaneous equipment. The power house and the barn are built upon land not owned by the merged corporations or any of them at the time of the merger. What is even more important, they serve the uses, not only of the Steinway line, but of all the other lines that have been operated since the merger by the merging corporation. Each road has been subject from the beginning to its own independent mortgage with after-acquired property clauses substantially the same. In these circumstances there is no more reason for holding the new buildings to be accessions to one road than for holding them accessions to the others. If accessions to one, they must have been accessions to all, and this in uncertain proportions, fluctuating from year to year with the extent and nature of the use. Title by accession imports something more, however, than an executory right to acquire a lien or interest in the future through the judgment of a court of equity. It imports a lien or interest presently valid alike in equity and at law. If the use of the power house and the barn for the benefit of the merged lines gives any interest at all to the underlying mortgagees, it is at most a right to compel the creation of a lien in equitable proportions as an incident to the jurisdiction to enforce the specific performance of a covenant. The reasons have already been stated why the covenant is unenforceable against an assignee or a purchaser as to later acquisitions. If those reasons are valid and the property is not subject to an equitable mortgage through the operation of the covenant, the gap cannot be bridged and the difficulty avoided by rejecting the covenant in form and enforcing it under a new name, either accession or something else. What is involved is more fundamental than adherence to a ritual.

Since neither estoppel nor accession will extend the underlying lien to the power house or barn, it remains to be considered whether there is to be discovered some other equity whereby the extension can be justified. We are told that such an equity exists in the necessity of providing the underlying mortgagees with a substituted security as compensation for what was lost when the barn and the power house were abandoned or dismantled. Withhold this security, it is said, and through the action of the merging corporation the subject-matter of the mortgage will have become a mere shell, a railway without power to move cars, without cars to be moved, and without barns in which to store cars. Granting, though provisionally only, that these consequences, if real, would supply the foundation of an equity, the assumption of their existence has its origin in a misconception of the facts. The Steinway mortgage was either a lien on the new power house and the new barn at the time of their construction, or it was never a lien at all. If it was not a lien at that time, then the lien of the new consolidated mortgage attached eo instanti for the benefit of the consolidated mortgage bondholders, and the plaintiff, to prevail, must be able to show that the lien thus attaching has been divested or subor-

dinated. But plainly there was no impairment of the security of the underlying Steinway mortgage, no reduction of the Steinway line to the state of an empty shell, when the lands for the new barn and the new power house were acquired by the merging corporation and the new buildings were erected. The land for the new barn was acquired in 1896, and the work of construction completed a short time thereafter. The old barn was not destroyed, and upon a sale of the Steinway line at that time under a judgment of foreclosure it would have gone to the purchaser along with the line itself. Indeed, it will go even now, for the tools, and the tools only, have been taken from the shops, which were already out of date. The new power house was acquired and put in operation in 1908, but for nearly a year thereafter the machinery in the old power house was oiled and kept in good condition, with the result that a buyer at a foreclosure sale at that time would have become the owner of the line intact, equipped for present use. The old power house is still there, but the machinery has been sold as junk, and the proceeds, about $14,000, have been allocated to the reduction of the Steinway lien. In the meantime, however, before the machinery was scrapped, the lien of the consolidated mortgage had attached to the new improvements, there being nothing in the purchase of the land or the construction of the buildings that made it necessary to destroy or remove any part of the security. Very likely the trustee for the Steinway bondholders might have enjoined the merging corporation from wasting the security by the later removal of any part of the old equipment. No such injunction was sought, not improbably for the reason that the bondholders had more to gain from economy of operation by a consolidated company and the application of the income to the payment of interest on the bonds than from the preservation of tools and machinery in the contingency at some distant time of a sale under foreclosure. At all events, the line was not a shell when the newly-acquired property came under the lien of the consolidated deed of trust. During a substantial period thereafter, it was maintained, not only with its own power house and barn, but with equipment and machinery properly kept up. For any loss that has been suffered through the removal at a later time of this equipment and machinery, the plaintiff had its remedy, equitable or legal. Even now it does not show the relation between the value of the equipment and machinery and the value of the land and buildings, part of the old line. The failure of the Steinway bondholders or of the plaintiff as their spokesman to take advantage of remedies, preventive or reparative, did not divest a lien in favor of the consolidated bondholders attaching in the interval.

What has been written as to the lien upon the power house and the barn supplies the answer to the question as to the liens upon the rolling stock, supplies, and miscellaneous equipment. In respect of the liens upon the rolling stock, the appeal is by the plaintiff, the trustee for the Steinway bondholders; in respect of the tools, supplies, and miscellaneous equipment, the appeal is by the Bankers' Trust Company, the trustee for the bondholders under the consolidated mortgage. The cars in use by the merged lines at the date of the merger are no longer in existence. The cars now in existence were bought

by merging corporation, and with the exception of nineteen cars which were subjected to the Steinway lien were never allocated to any special line, but were used indiscriminately for all. In the absence of a covenant, the merging corporation did not subject the new cars thus indiscriminately used to the underlying liens. New York Security & Trust Co. v. Louisville & St. L. & Consol. R. Co., supra, at page 398, of 102 F.; Mississippi Valley Trust Co. v. Southern Trust Co., supra [C. C.A., 261 F. 765]; Metropolitan Trust Co. of City of New York v. Chicago & E. I. R. Co., supra, at page 878 of 253 F.; Hinchman v. Point Defiance Ry. Co., 14 Wash. 349, 44 P. 867; United States v. New Orleans & O. R. Co., 12 Wall. 362, 20 L.Ed. 434. The situation might be different if they had been allocated specifically or even chiefly to the use of a particular road. Commercial Trust Co. v. Chattanooga Ry. & L. Co., supra [D.C., 281 F. 856]. There is no need to dwell upon the difference, for the defendant trust company does not appeal from the segregation to the plaintiff of the cars appropriated to its use by the act of the receivers.

On the other hand, the application of the same principle that excludes the cars generally forbids the subjection of the tools, supplies, and miscellaneous equipment to the lien of the underlying mortgages, and requires a modification of the judgment, on the appeal of the Bankers' Trust Company, by declaring them to be subject to the prior and superior lien of the consolidated mortgage.

The property 7 and 9 Borden avenue was correctly held to be within the coverage of the Steinway mortgage, since title thereto was taken in the name of the Steinway company, without reservation or condition.

The land, the buildings, and the equipment, the subject of this controversy, were paid for with moneys supplied by the consolidated mortgage bondholders. Without the aid of those moneys the unified operation of the lines would have been impossible, and the underlying bondholders would have lost the benefit of economies and facilities incidental to the merger. As a consequence of the merger, or at least as its sequel, foreclosure has been warded off for upwards of twenty-five years, and an income has been earned from which interest has been paid on the underlying obligations.

From the viewpoint of economics, the furtherance of business interests, there have thus arisen equities in favor of the consolidated bondholders that may not be ignored altogether in determining their equities from the viewpoint of the law. To the extent that improvements, though made upon newly-acquired lands through the use of the new loan, have been charged with a lien, declared with reasonable clarity, in favor of underlying mortgage bondholders, the courts will give effect, through the remedy of specific performance, to the ensuing equitable right. On the other hand, the advantages incidental to merger and consolidation would be discouraged, and new loans would be precarious, if less than reasonable clarity were exacted as a condition of subordination and extension.

The judgment of the Appellate Division should be modified by declaring the tools, supplies, and miscellaneous equipment to be subject

to a prior lien in favor of the trustee under the consolidated mortgage, and as modified affirmed without costs to either party.

Judgment accordingly.[1]

NOTE

(A) It seems clear that nowadays a corporation has the general power to mortgage after-acquired property, a power which need not be asserted in its charter. *Quasi* public corporations have had this power granted without question; in fact, the right to mortgage after-acquired property has sometimes been stated to be confined only to such class of corporations. However, there seems to be no logical reason for this distinction and the power to mortgage such property has been generally extended to business corporations. Of course, to cover after-acquired property, the mortgage should contain words of futurity or language showing clearly the intention to impose a lien upon such property. * * *

The form of description commonly used in corporate mortgages refers to after-acquired property in quite general terms. Rather than construing these clauses in the broad sense used by the draftsman, the courts have imposed several limitations upon them. The first of such limitations is that only that type of property which is mentioned in the other descriptive phrases in the mortgage will be considered as included. * * *

* * * Hence, most corporate mortgages describe in minutest detail all of the various types of property that may be subsequently owned by the corporate mortgagor. While it is generally true that a mortgage is read as a whole in determining what property is covered thereby, a mortgage of property by general description, when no particular property is referred to, will neither confer any title to, nor create any lien upon, similar property acquired thereafter. Conversely, where a mortgage fails to describe certain property then owned by the mortgagor, an after-acquired property clause will not be construed to create a lien on such property. * * *

The case of Morrill v. Noyes has suggested two other rules which are of particular help in considering the problem of after-acquired property: 'The contract must relate to some particular property described therein, which, though not in existence, must be reasonably certain of coming into existence, so that the minds of the parties may be in agreement as to what it is to be. * * * Second, the mortgagor must have a present actual interest in it or concerning it. There must be something *in praesenti* of which the thing *in futuro* is to be the product or with which it is to be connected as necessary for its use or as expedient to it constituting a tangible, existing basis for the contract.' For example, it has been held that the words, 'intending hereby to include all its present real and personal estate and franchises, now owned or hereafter to be acquired, without any exception or reservation,' in a railroad mortgage are too indefinite to cover after-acquired property not otherwise described. Similarly, the words 'all other machinery, plants, tools and equipment which the company may hereafter acquire' do not bring under a mortgage a tract of land used for the business of the corporation but located miles distant from its factory. * * *

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1 Motion for reargument denied, per curiam, 254 N.Y. 126, 172 N.E. 264, 1930. Appeal dismissed for want of a substantial federal question, 282 U.S. 803, 51 S.Ct. 86, 75 L.Ed. 722, 1930.

1931, 44 Harv.L.Rev. 472. See, also, Foley and Pogue, After-Acquired Property under Conflicting Corporate Mortgage Indentures, 1929, 13 Minn.L.Rev. 81; Hamilton, Future Property Clauses in Corporate Mortgages, 1930, 4 Temple L.Q. 131; Goodbar, Conflicting Corporate Mortgage Indentures and After-Acquired Property, 1932, 12 B.U.L.Rev. 648; Klooster, Mortgages of After-Acquired Railroad Property, 1933, 27 Ill.L.Rev. 781; Developments in the Law—Corporations—1931, 1932, 45 Harv.L.Rev. 1374, 1403; Notes, Effect of After-Acquired Clause on Property Later Acquired under Charter Amendment, 1936, 49 Harv.L.Rev. 947; 1932, 41 Yale L.J. 466; 1941, 39 Mich.L.Rev. 503.

The converse of the above limitation is also true, i. e., that property which the mortgagor has no power to accept at the time a mortgage is executed is not included in the lien of an after-acquired property is not in contemplation or not in existence at the date of the mortgage is no reason why the property, when acquired, should not pass under such mortgage. * * *

A further limitation imposed upon the after-acquired property clause is that the property acquired must be necessary or proper for the business of the mortgagor as of the time the mortgage was executed, or must be usable in replacing such property. * * *

* * * Such limitation is not burdensome, for, in most cases, the purchasers of a bond issue, aware that the value of a corporate property to a large extent depends upon its use as a going concern, require only that the mortgage shall cover such after-acquired property as is used in connection with or for the purposes of the business. McClelland and Fisher, The Law of Corporate Mortgage Bond Issues, Callaghan and Company, 1937, pp. 317-324.

(B) A mortgage intended to cover after-acquired property can only attach itself to such property in the condition in which it comes into the mortgagor's hands. If that property is already subject to mortgages or other liens, the general mortgage does not displace them, although they may be junior to it in point of time. It only attaches to such interest as the mortgagor acquires; and if he purchase property and give a mortgage for the purchase money, the deed which he receives and the mortgage which he gives are regarded as one transaction, and no general lien impending over him, whether in the shape of a general mortgage, or judgment, or recognizance, can displace such mortgage for purchase money. And in such cases a failure to register the mortgage for purchase money makes no difference. It does not come within the reason of the registry laws. These laws are intended for the protection of the subsequent, not prior, purchasers and creditors. United States v. New Orleans Railroad, 12 Wall. 362, 365, 20 L.Ed. 434, 1871. See, also, 1941, 39 Mich.L.Rev. 503.

(C) An after-acquired property clause in a mortgage prevents a corporation from doing any future financing except with junior mortgages. In order to circumvent such a clause, the following devices have been used: (1) purchase money mortgage; (2) organizing a subsidiary to take title to later acquired property; (3) consolidation. A suggestion is made that "the court may distinguish the effect (of a broad after-acquired property clause) upon acquisitions made by virtue of corporate powers existing at the date of the mortgage from its operation upon property acquired under subsequent charter amendments. As to the latter, a security interest may be denied even against a subsequent general creditor, while at the same time it will be recognized as to the former on principles of specific performance." Note, 1936, 49 Harv.L.Rev. 947. See, also, Berle, Studies in the Law of Corporation Finance, 1928, c. VIII, esp. 163–174 (same appears Subsidiary Corporations and Credit Manipulation, 1928, 41 Harv.L.Rev. 874); Dewing, The Financial Policy of Corporations, 4th Ed., 1941, Vol. I, 202–203; Montgomery, Financial Handbook, 2d Ed., 1933, 435; Blair, The Allocation of After-Acquired Mortgaged Property Among Rival Claimants, 1926, 40 Harv.L.Rev. 222; Notes, 1924, 24 Col.L.Rev. 523; 1935, 7 Rocky Mt.L.Rev. 264.

(D) On the effect of a promise to mortgage already acquired property for the benefit of bondholders, see Note, 1920, 33 Harv.L.Rev. 456.

2. INCOME CLAUSE

NOTE

Almost all trust indentures mortgaging physical property convey the described property "together with the rents, issues, tolls, revenues,

income and profits thereof." This is generally coupled with a defeasance clause permitting the mortgagor until default to operate the business, collect the income and apply it to current expenses. Obviously, this is a form of mortgage of after-acquired property, because the income is not in being at the date of the mortgage. Whether or not the granting clause contains this language, such an indenture will invariably provide that upon the happening of a default the trustee may enter upon the mortgaged property, operate it and take the net income for the benefit of the bondholders. As a practical matter, the trustee exercises its right to enter by applying to the court for the appointment of a receiver in foreclosure. Some indentures therefore provide in addition that in any suit to foreclose, the trustee shall be entitled to the appointment of a receiver as a matter of right. Most jurisdictions will enforce this clause specifically: e. g. N. Y. Gen. Corp. Law, § 150; Guaranty Trust Co. v. Feldman, 247 Mich. 524, 226 N.W. 233 (1929). A few jurisdictions however hold that the clause purporting to confer the privilege of appointing a receiver as a contractual right is void as against public policy; thereby the mortgagor is permitted to retain possession until the period of the equity of redemption has expired: e. g. Teal v. Walker, 111 U.S. 242, 4 S.Ct. 420 (1884).

The interesting feature about the mortgage of income is that, despite the broad language of the granting clause of the mortgage, the courts generally will not enforce the right of the trustee to get income which accrued prior to the date of the appointment of a receiver in foreclosure or, in a bankruptcy case where foreclosure is enjoined, prior to the entry of an order "impounding" the income for the benefit of the bondholders. This rule applies even though the foreclosure receiver, when he goes into possession, may find considerable cash in the bank, the obvious source of which was income of the mortgaged property. Nor is there any distinction in applying the rule as to income earned prior to default (American Bridge Co. v. Heidelbach, 94 U.S. 798 (1876)) and income earned between the date of default and the date of the appointment of a receiver (Galveston R. R. v. Cowdrey, 11 Wall., 459 (U.S.1870) 93 U.S. 352 (1876)). Thus a receiver appointed on a general creditors' bill would hold the income for the benefit of general creditors. When a junior mortgagee intervenes and has the receivership extended to his foreclosure suit, he is entitled to the income. From the date of intervention by the senior mortgagee, the receiver is accountable to him: Sullivan v. Rosson, 223 N.Y. 217, 119 N.E. 405 (1918).

The modern corporate indenture is drawn in recognition of these rules, despite the fact that Chapter X of the Bankruptcy Act has made foreclosure an outmoded remedy. The indenture trustee will at the earliest practicable moment seek an order of the Bankruptcy Court directing that the bankruptcy trustee operate the mortgaged property for account of the indenture trustee and the bondholders, to the end that should reorganization fail, the bondholders' security will not be impaired in the interim. Suppose, however, that the operation has been conducted at a deficit. Under the old cases the mortgagee was not chargeable with that deficit if he had not sought the appoint-

ment of a foreclosure receiver (MacGregor v. Johnson-Cowdin-Emmerich, 31 F.2d 270 (C.C.A.2d, 1929)). This point has not been decided under the bankruptcy statutes. See generally, Israels & Kramer, The Significance of the Income Clause in a Corporate Mortgage (1930) 30 Col.Law Rev. 489.

3. NEGATIVE PLEDGE CLAUSE

INDENTURE JUNE 1, 1938, THE MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY AND THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK (AS TRUSTEE), ART. 2.

SECTION 4. Except in the case of purchase-money mortgages and liens, if the Telephone Company shall at any time mortgage, pledge or otherwise subject to any lien the whole or any part of any property or assets now owned or hereafter acquired by it, it will secure the debentures outstanding hereunder ratably with the indebtedness or obligations secured by such mortgage, pledge or lien; provided, however, in case of a consolidation or merger of the Telephone Company with or into any other corporation which shall execute an instrument with the Trustee as provided in Section 2 of Article Nine, or a sale or conveyance of the property of the Telephone Company as an entirety or substantially as an entirety to any such corporation, this covenant shall not apply to any property or assets of such successor corporation, except (a) physical property, franchises and securities acquired from the Telephone Company, (b) improvements and additions to, and renewals and replacements of, any physical property so acquired, (c) franchises in substitution for, or renewal of, any franchises so acquired, and (d) securities issued in substitution or exchange for securities so acquired; and provided, further, that this covenant shall not apply to the making of any deposit or pledge with any governmental agency at any time required by law in order to qualify the Telephone Company to conduct its business or any part thereof or in order to entitle it to maintain self insurance or to obtain the benefits of any law relating to workmen's compensation, unemployment insurance, old age pensions or other social security, or with any court, board, or commission as security incident to the proper conduct of any proceeding before such court, board or commission. Subject to the provisions of Section 6 of this Article, nothing herein contained shall prevent a subsidiary of the Telephone Company from mortgaging, pledging or subjecting to any lien property or assets whether or not acquired by such subsidiary from the Telephone Company.

SECTION 5. If, upon any consolidation or merger of the Telephone Company with or into any other corporation, or upon any sale or conveyance of the property of the Telephone Company as an entirety or substantially as an entirety to any other corporation, any of the property or assets of the Telephone Company would thereupon become subject to any mortgage, pledge or lien, the Telephone Company, prior to such consolidation, merger, sale or conveyance

will secure the debentures outstanding hereunder by a direct lien on all such property or assets of the Telephone Company, prior to all liens other than any theretofore existing thereon.

SECTION 6. For the purposes of this Section 6, the word "securities" means stock, bonds, debentures, notes, and all other indebtedness (whether or not evidenced by any bond, debenture, note or other written instrument) arising from borrowing or otherwise, except indebtedness (other than that arising from borrowing) incurred in the ordinary course of business; and the term "wholly-owned telephone corporation" means an operating telephone company of which the Telephone Company owns all the outstanding securities which such corporation may have issued, incurred, assumed or guaranteed, excepting only securities held by the trustee of any pension fund established by such corporation, and shares necessary to qualify its directors.

The Telephone Company covenants:

(a) that it will not sell or otherwise dispose of all or substantially all of its telephone plant in one or more states, except to a wholly-owned telephone corporation;

(b) that it will not sell or otherwise dispose of any securities issued, incurred, assumed or guaranteed by any wholly-owned telephone corporation, except to such corporation itself, or to qualify its directors;

(c) that no wholly-owned telephone corporation will sell or otherwise dispose of all or substantially all of its telephone plant in one or more states, except to the Telephone Company;

(d) that no wholly-owned telephone corporation will issue, incur, sell or otherwise dispose of any of its own securities, except to the Telephone Company, or to the trustee of any pension fund established by such wholly-owned telephone corporation, or to qualify its directors; and

(e) that no wholly-owned telephone corporation will assume or guarantee any securities of any other person or corporation, except securities held by the Telephone Company;—

if, in any such case, immediately thereafter, the principal amount of all outstanding bonds, debentures, notes, and other indebtedness (whether of not evidenced by any bond, debenture, note or other written instrument) arising from borrowing or otherwise, except indebtedness (other than that arising from borrowing) incurred in the ordinary course of business, issued, incurred, assumed or guaranteed by the Telephone Company would exceed an amount equal to 35% of the amount of the telephone Company's gross investment in telephone plant of all wholly-owned telephone corporations then existing, all as shown by the accounts of the Telephone Company and of such corporations. The aforesaid provisions shall not restrict the amount of bonds, debentures, notes or other indebtedness which may be issued, incurred, assumed or guaranteed by the Telephone Company.

PART V

MANAGEMENT AND OPERATION

MANAGEMENT

Corporation laws and corporate charters contemplate the creation of a clearly defined management group. This comprises the Board of Directors, which in turn selects the senior officers, and gives to these officers general or limited power. The stockholders may lay down ground rules by adopting By-Laws determining the number of directors, the method by which they shall act, and the powers which may be conferred on the officers. The persons who accept office under this arrangement assume the responsibilities of management by the very fact of their holding office.

It has been common to refer to this group as the "titular management", the individuals who have the power and the right to manage by election on choice.

Yet others may and frequently do "manage" corporations. Thus a single stockholder (perhaps a parent of a subsidiary corporation, or one individual owning enough stock to control the annual elections) can dictate who shall be the directors and officers; can choose men responsible to his will; and can, if he desires, direct their actions as managers. This is not his right; but it is his power. In consequence, though not titulary managers, such persons may become managers in fact; and, as will be seen, the law recognizes the existence of a "dominant" stockholder.

Conceivably other persons may likewise put themselves in a position to dominate management—for instance, a creditors' committee; possibly the licensor of a patent; conceivably even a political boss or racketeer. Any of these may acquire power to dictate management acts and policies; and may factually use it. Do they also become "managers", or subject to the rules restricting and effecting those holding management responsibilities?

Finally, certain limited powers are reserved to stockholders acting as stockholders—for instance, the right to dissolve the corporation. This is, in a sense, an act of management—one of the few which stockholders as such may perform by vote. In these instances, is a majority of shareholders affected by the limitations thrown around "management"? Or may they coldly take the position that, since they own the stock, they may vote it for any reason, including a bad one, irrespective of the effect their vote may have on other shareholders?

The law of titular management responsibility is well developed. The application of that law to non-titular management, that is to persons who have acquired the power to manage, and who have used that power, is relatively new, and develops with each succeeding fact-situation.

NOTE

(A) In the relatively small individual proprietorship, the owner-manager is clearly the business leader. He is the one whose decisions determine directly the course of his firm's operations, and his active leadership and the risk-taking inherent in owning a business were the two standard elements traditionally attributed by economists to the entrepreneur. In the large corporation, however, these two elements have to be separated. Positive leadership is not generally performed by those who, through ownership, risk their property and receive profits. The situation is made even more complex by the fact that the leadership elements have become diffused among a hierarchy of salaried executives, directors, stockholders, and sometimes one or more outside groups.

Business leadership must be exercised in an economic system characterized by large corporate units as well as in a system in which small-scale business predominates. The fact that the legal owners (that is, holders of stock) have to a very large degree been eliminated from active leadership does not in any way obviate the necessity for the performance of the leadership function. In fact, the need for the function becomes greater the larger enterprises become. It is true, however, that when we attempt to apply the concept of business leadership to the large corporation, we encounter serious complications, and a concept that seemed clear-cut becomes vague and difficult of application. The chief problem arises from the fact that authority and responsibility in the large firm are divided among different men, and in a number of different ways.

In the large corporation, the following groups may participate, in varying ways, in business leadership:

1. Stockholders, who are nominally responsible for selecting directors, but who in practice may have no influence either in choosing them or in making any other important business decisions.

2. Various outside groups—bondholders, bankers, and so on—whose power may be great enough to give them a voice in selecting directors or otherwise influencing those responsible for decision-making.

3. The board of directors, which may be entirely passive, may select executives but otherwise make no decisions and exercise no real veto power, or may regularly share with executives in making important decisions.

4. The top executives, who are chiefly responsible for the formulation of the more important decisions, the choice of subordinates, and the creation and maintenance of an adequate organization.

5. Minor executives, who administer the broad policies laid down at the top and, as a part of such administration, formulate decisions of a scope narrower than those handed down to them by the top executives.

Thus the function of business leadership becomes divided through a process of vertical division that we call "delegation." The process is further complicated by the horizontal division which takes place. On the same plane of authority the making of decisions may be shared by two or more persons, acting either as a group or in their individual capacities. For example, whatever decisions are made by the board of directors are likely to be made by two or more men, though not necessarily by the board as a whole. Further, though one executive may be formally the chief operating officer, major policies may actually be formulated jointly by himself and one or more other executives of prominence in the company. Similarly, many operating policies in large concerns are formulated today by committees rather than by single individuals. This horizontal division occurs again when policy formation is specialized at a given level of authority. Thus the president may make the important operating decisions; a committee of the board or the chairman of the finance committee may have control over major financial decisions. Neither can be considered subordinate to the other, though the board may view

the financial decisions as being of greater importance than those affecting production or sales. At a lower level of authority we have "vice presidents in charge of" anything from production to public relations.

This complicated situation has been the despair of those economists who have considered at all the problem of leadership in the large corporation. There is no general agreement as to how the function of business leadership should be defined or as to who performs this function in the large corporation. We shall not concern ourselves with the problem of which words should be applied to which concepts. The indisputable fact is that business is still being led and controlled and that the co-ordination of production toward desired ends is still taking place. If business leadership has disappeared as a single unified function, we must nevertheless discover how the necessary business decisions are made in this complex situation.

Our key to handling this problem will be to find out who in fact make the various decisions and policies which we include in the leadership function. We shall consider the men actually making these decisions as exercising some part of business leadership—regardless of whether higher up in the hierarchy of nominal authority there is some one else who *could* hire or fire this person or *could* make these decisions himself if he so chose. Business leadership consists, then, at least in part, of actually making certain broad decisions which determine the general nature of the firm's activities. R. A. Gordon, Business Leadership in the Large Corporation, (1945) 46–49.

(B) Let us take a hypothetical and over-simplified example in order to make more precise what is meant by "management" and to separate this off from other ideas which are often grouped with it. We will let our example be an imaginary automobile company. In connection with the ownership, control, and management situation in relation to this company, we may distinguish the following four groups:

1. Certain individuals—the operating executives, production managers, plant superintendents, and their associates—have charge of the actual technical process of producing. It is their job to organize the materials, tools, machines, plant facilities, equipment, and labor in such a way as to turn out the automobiles. These are the individuals whom I call "the managers."

It should be observed that the area of production which any group of them manages is most variable. It may be a single small factory or mine or a single department within a factory. Or it may be a large number of factories, mines, railroads, and so on, as in the case of the chief managers of the great United States corporations. In theory the area could be extended to cover an entire interrelated branch of industry (automobiles, mines, utilities, railroads, whatever it might be) or most, or even all, of the entire mechanism of production. In practice in the United States at present, however, there do not exist managers *in this sense* for whole branches of industry (with possibly one or two exceptions), much less for a major portion or all of industry as a whole. The organization and co-ordination of industry as a whole is carried on through the instrumentality of "the market," without deliberate and explicit management exercised by specific managers, or indeed, by anyone else.

2. Certain individuals (among whom, in the United States at present, would ordinarily be found the highest ranked and best paid of the company officials) have the functions of guiding the company toward a *profit;* of selling the automobiles at a price and in the most suitable numbers for yielding a profit; of bargaining over prices paid for raw materials and labor; of arranging the terms of the financing of the company; and so on. These functions are often also called those of "management" and those who fulfill them, "managers." However, there is clearly no necessary connection between them and the first type of function. From the point of view of the technical process of production, a car would be neither worse nor better because of what it sold for (it could be given away and still be the same car, technically speaking) or what the materials which went into it cost; nor, so far as technical problems go, does the difference between

bank loans at 4% or 5% show up in the power of the motor, or a change in dividend rate alter the strength of the frame.

In order to distinguish this group from the first, I shall call the individuals who make it up "finance-executives" or simply "executives," reserving the terms "management" and "managers" for the first group only.

3. Certain individuals (among whom in the United States at present would be many of the directors of the company and more particularly the bankers and big financiers who actually appoint the directors) have problems different from either of the first types. Their direct concern is not, or need not be, either the technical process of production or even the profit of the particular company. Through holding companies, interlocking directorates, banks, and other devices, they are interested in the financial aspects not merely of this automobile company but of many other companies and many market operations. They may wish to unite this company with others, in order perhaps to sell a stock or bond issue to the public, independently of the effect of the merger on the technical process of production or on the profits of our original company. They may want, for tax or speculative or other reasons, to lower the profit of this company, and could do so, by, for example, raising prices charged by supply companies which they also were interested in. They may want to put some competitors out of business or influence politics or inflate prices; and any of such aims might be altogether independent of the requirements of production or profit in the particular automobile company. Any number of variants is possible. I shall call this third group the "finance-capitalists."

4. Finally there are certain individuals (a comparatively large number as a rule in the United States at present) who own in their names stock certificates in the automobile company and who are formally and legally the "owners" of our company. In fact, however, the great bulk of them, comprising in sum the legal "owners" of the substantial majority of the stock of the company, have an entirely passive relation to the company. The only right they possess with reference to the company is to receive, as against those who do not have stock certificates registered in their names, money in the form of dividends when on occasion dividends are declared by the directors.

This four-fold separation into "managers," "executives," "finance-capitalists," and "stockholders" is, in reality, a separation of *function* of four of the types of relation in which it is possible to stand toward a certain section of the instruments of production. It is theoretically possible, therefore, that one and the same individual, or one and the same group of individuals, should perform all four of these functions, should stand in all four of these relations to the instruments of production in question (in our hypothetical case, the tangible assets of the automobile company). That is, one and the same individual (Henry Ford, as of some years ago, was a late and favorite example) or group of individuals could manage the production of the company, direct its policy so as to make a profit, integrate its activities in relation to banks and to other companies (if such were in question), and be the sole stockholder of the company. Not only is such an identity possible: until comparatively recently, it was normally the case.

Today, however, it is seldom the case, especially in the more important sections of industry. The four functions are much more sharply differentiated than in the past; and they are, as a rule, performed by different sets of persons. It is not always so, of course; but it tends to become more and more so. Even where there is overlapping, where the same individual performs several of these functions, his activities in pursuit of each are easily separable.

Two further facts about these groups may be noted: In most large corporations, which together are decisive in the economy, the bulk of the stockholders, holding in their names the majority of the shares of stock, have, as everyone knows, the passive relation to the company which has been referred to. With only the rarest exceptions, they exercise no real control over the company except for the

minor element of control involved in their preferential sharing (as against non-stockholders) in the profits, or rather the declared dividends, of the company. But the third group in our list (the finance-capitalists) are also, some of them at any rate, stockholders. Together they usually do not own in the legal sense a majority of the shares, but they ordinarily own a substantial block of the shares, and have at their disposal liquid funds and other resources whereby they can, when need arises, obtain from the small stockholders enough "proxies" on stock shares to be able to vote a majority.

Thus this third group is in a legal position of ownership toward the company and the instruments of production included among the company's assets: if not with the unambiguous title of an earlier capitalist, who in his own name owned all, or a majority of, the shares of a company, at least to a sufficient degree to preserve the meaning of the legal relationship.

Sometimes the executives of Group 2 are also included in Group 4 and have substantial legal interests of ownership in the company (that is, have registered in their own or their families' names substantial blocks of the company's stock). But this is very seldom the case with the managers proper, with the members of Group 1; these ordinarily have no legal ownership interest in the company, or at most a very small interest: that is, they are not usually large stockholders in the company.

Second, there is a complete difference among these groups with respect to the *technical* role of their respective functions in relation to the process of production. The process of production is technically and literally impossible unless someone is carrying out the functions of management, of Group 1—not necessarily the same individuals who carry them out today, but, at any rate, someone.

Some of the finance-executive functions comprised in Group 2 are also technically necessary to the process of production, though not necessarily in the same sense as today: that is, not necessarily (from a technical point of view) for the sake of profit as understood by capitalism. There must be some regulation of the quality, kinds, numbers, and distribution of products apart from the theoretic abilities of the instruments of production to turn products out. This regulation would not have to be achieved, however, as it is through the finance-executives, in terms of capitalist profits for the company. It could be done in subordination to some political or social or psychological aim—war or a higher standard of mass living or prestige and glory or the maintenance of some particular power relationship. In fact, with profit in the capitalist sense eliminated, the *technically necessary* functions of the finance-executives of Group 2 become part of the management functions of Group 1, if management is extended over all or most of industry. Management could, that is to say, absorb all of the technically necessary functions of the non-managing executives.

But, still from a strictly technical viewpoint, the remaining functions—the "profit-making" functions—of Group 2 and all the functions of Groups 3 and 4—finance-capitalist and stockholder—are altogether unnecessary (whether or not desirable from some other point of view) to the process of production. So far as the technical process of production goes, there need not be finance-capitalists or stockholders, and the executives of Group 2, stripped of many of their present functions, can be merged in the management Group 1.[1]

Not only is this development conceivable: it has already been almost entirely achieved in Russia, is approached more and more nearly in Germany, and has

[1] I must warn that this fourfold division which I have made bears no relation to the usual division between "industrial capitalists" and "finance-capitalists." This latter distinction is of great importance in studying the hisorical development of capitalism, but seems to me of little value in the analysis of the structure of present-day capitalism. In particular, it is of no value in connection with the central problem of this book.

gone a considerable distance in all other nations. In the United States, as everywhere, it is precisely the situation to be found throughout *state enterprise*.

This development is a decisive phase of the managerial revolution. * * *

The so-called "separation of ownership and control," paralleling the growth of the great public corporations of modern times, has, of course, been a widely recognized phenomenon. A decade ago it was the principal subject of the widely read book, The Modern Corporation and Private Property, by Berle and Means. In this book, the authors showed that the economy of the United States was dominated by the two hundred largest nonbanking corporations (they did not discuss the relations of these to financial houses); and, second, that the majority of these corporations were no longer, in practice, controlled by their nominal legal owners (that is, stockholders holding in their names a majority of the shares of stock).

They divided these corporations according to "types of control." In a few, control was exercised by a single individual (more often, single family) who was legal owner of all or a majority of the stock; in others, by individuals or groups which owned not a majority but a substantial percentage of the stock. Most, however (in 1929, 65% of these 200 corporations with 80% of the total assets), they decided were what they called, significantly enough, "management controlled." By "management-controlled," as they explained, they meant that the management (executives) of these companies, though owning only minor percentages of the shares of their corporations, were in actuality self-perpetuating, in control of the policies and the boards of directors of the companies and able to manipulate at will, through proxies, majority votes of the nominal owners, the shareholders. The American Telephone and Telegraph Corporation is the classic example of "management-control."

Though briefly, Berle and Means also took up the extremely important point that in the nature of the case there were sources of frequent conflict between the interests of the "control group" (most often, the management) and the legal owners. This is apparent enough to anyone who recalls the economic events of the past generation. Many books have been written about the difficulties of the run-of-the-mine common stockholders, often as a result of the policies of the "control group" of "their own" company. Wealth, power, and even other possible interests (such as maximum industrial efficiency) of the control group quite naturally do not often coincide with maximum dividends and security for the common stockholders.

The analysis by Berle and Means is most suggestive and indirectly a powerful confirmation of the theory of the managerial revolution, but as it stands it is not carried far enough for our purposes. In their concept of "management-control" they do not distinguish between management in the sense of actual direction of the process of production (the sense of our Group 1 and the only sense in which we refer to "management") and management in terms of profit, selling, financing, and so on (our Group 2, the finance-executives). Indeed, their use of "management," as is usually the case, is closer to the latter than the former, which results really from the fact that in most big corporations today the chief and best-known officials are of the second or executive, not of the first or manager, type. Moreover, Berle and Means do not include any study of the way in which their supposedly self-perpetuating and autonomous managements are in actuality often controlled by big banks or groups of financiers (our Group 3).

One result of such a refinement and amplification of the Berle and Means analysis would be to show that the sources of possible and actual conflict among the groups are far more numerous and more acute than they indicate. Among these sources, three should be stressed:

1. It is a historical law, with no apparent exceptions so far known, that all social or economic groups of any size strive to improve their relative position with respect to power and privilege in society. This law certainly applies to the four groups into which we have divided those who stand in some sort of relation of own-

ership, management, or control toward the instruments of production. Each of these groups seeks to improve its position of power and privilege. But, in practice, an improvement in the position of one of them is not only not necessarily an improvement for the others; often it means a worsening of the position of one or all of the others.

In periods of great prosperity and expansion, this is not very irritating, since all four can advance relatively as against the rest of society; but, as we have already seen, such periods have ended for capitalism. In conditions which are now normal, an increase in income for the managers or even the executives of Group 2 means so much the less for Group 3 (the financiers) and Group 4 (the stockholders.)

Even more apparently, the relations of control over the operations of the instruments of production raise conflicts, since the sort of operation most favorable to one group (expanding or contracting production, for example) very often is not that most favorable to another. And, in general, there is a source of permanent conflict: the managers proper receive far less reward (money) than the executives and especially the finance-capitalists, who get by far the greatest benefits. From the point of view of the manager group, especially as economic conditions progressively decay, the reward allotted to the finance-capitalists seems inordinate and unjustified, all the more so because, as the managers see it more and more clearly, the finance-capitalists are not performing any function necessary to the process of production.

2. All four of these groups, to one or another degree, are powerful and privileged as against the great masses of the population, who have no interest or ownership, management, or control in the instruments of production and no special preferential treatment in the distribution of their products. Consequently, the masses have a tendency to strive for a greater share of power and privilege as against all four of these groups. The result of this situation might be expected to be a merging of the conflicts among the four groups and a common front against the pressure of the masses. This has indeed been often the case. Nevertheless, the conflicts among the groups are real and cannot be eliminated even in the face of a common danger. In fact, the presence of the common danger is itself a source of new conflicts. This follows because the groups, from the very status they occupy and functions they fulfill, favor different methods of meeting the danger and of maintaining privilege as against the masses. The differences become sharpened under the crisis conditions of contemporary capitalism. This can be made clear by a single example:

The position, role, and function of the managers are in no way dependent upon the maintenance of capitalist property and economic relations (even if many of the managers themselves think so); they depend upon the technical nature of the process of modern production. Consequently the preservation of the capitalist relations is not an absolutely decisive question for the managers. The position, role, and function of the most privileged of all the groups, the finance-capitalists, are, however, *entirely* bound up with capitalist property and economic relations, and their preservation is decisive for even the continued existence of this group. This holds in general and cannot help affecting the situation with respect to more specific problems.

For instance, from the point of view of the technical position of the managers, the problem of unemployment is perfectly easy to solve: if the technical co-ordination and integration of industry were extended, unemployment could be wiped out in a month. Moreover, the managers, or many of them, are aware that unless mass unemployment is wiped out, all privileges, including their own, will be wiped out, either through national defeat by a nation which has wiped it out or by internal chaos. But mass unemployment cannot be eliminated without invading and finally abolishing capitalist property and economic relations. The position of the managers thus forces them toward solutions which would have such an effect.

But the finance-capitalists (and even the executives, for that matter) are differently situated. Their position, depending on the capitalist relations, thereby depends also on the continuance of mass unemployment; they cannot entertain any solution that has a chance of eliminating unemployment without involving at the same time their own elimination. (If they think they can, they are simply mistaken, as they are beginning to find out in Germany and will before long find out elsewhere.)

3. A third source of conflict is found in what we might call "occupational bias," a point to which we shall return later. The different things which these different groups do promote in their respective members different attitudes, habits of thought, ideals, ways and methods of solving problems. To put it crudely: the managers tend to think of solving social and political problems as they co-ordinate and organize the actual process of production; the nonmanagerial executives think of society as a price-governed profit-making animal; the finance-capitalists think of problems in terms of what happens in banks and stock exchanges and security flotations; the little stockholders think of the economy as a mysterious god who, if placated properly, will hand out free gifts to the deserving. Burnham, The Managerial Revolution, (1941) 82–92.

On the periphery of the "management" are groups whose status is in question. Thus in Packard Motor Car Co. v. National Labor Relations Board, 330 U.S. 485, 67 S.Ct. 789 (1947) the issue was whether foremen in a plant were "employees" having the right of organization and collective bargaining. The Company contended that foremen were a part of management, and therefore employers. A majority of the Court held that they were employees.

DOUGLAS, J., dissented.

PACKARD MOTOR CAR COMPANY v. NATIONAL LABOR RELATIONS BOARD.

Supreme Court of the United States, 1947. 330 U.S. 485, 67 S.Ct. 789.

Petition by the National Labor Relations Board to enforce an order issued against the Packard Motor Car Company, wherein the Foreman's League for Education and Association and another intervened. To review a judgment decreeing enforcement of the order, 6 Cir., 157 F.2d 80, the Packard Motor Car Company brings certiorari.

Affirmed.

MR. JUSTICE DOUGLAS, with whom THE CHIEF JUSTICE and MR. JUSTICE BURTON concur, dissenting.

First. Over thirty years ago Mr. Justice Brandeis, while still a private citizen, saw the need for narrowing the gap between management and labor, for allowing labor greater participation in policy decisions, for developing an industrial system in which cooperation rather than coercion was the dominant characteristic. In his view, these were measures of therapeutic value in dealing with problems of industrial unrest or inefficiency.

The present decision may be a step in that direction. It at least tends to obliterate the line between management and labor. It lends the sanctions of federal law to unionization at all levels of the industrial hierarchy. It tends to emphasize that the basic opposing forces

in industry are not management and labor but the operating group on the one hand and the stockholder and bondholder group on the other. The industrial problem as so defined comes down to a contest over a fair division of the gross receipts of industry between these two groups. The struggle for control or power between management and labor becomes secondary to a growing unity in their common demands on ownership. * * *

If foremen were to be included as employees under the Act, special problems would be raised—important problems relating to the unit in which the foremen might be represented. Foremen are also under the Act as employers. That dual status creates serious problems. An act of a foreman, if attributed to the management, constitutes an unfair labor practice; the same act may be part of the foreman's activity as an employee. In that event the employer can only interfere at his peril. The complications of dealing with the problems of supervisory employees strongly suggest that if Congress had planned to include them in its project, it would have made some special provision for them. * * *

A. MANAGEMENT IN FORMATION; PROMOTERS

1. FIDUCIARY DUTY OF PROMOTERS

HAYWARD v. LEESON.

SAME v. HOPEWELL.

Supreme Judicial Court of Massachusetts, Suffolk, 1900.
176 Mass. 310, 57 N.E. 656, 49 L.R.A. 725.

Two bills in equity filed in the Superior Court, by the receiver of the East Tennessee Land Company, to recover alleged secret profits made by the defendants as promoters of the corporation. The cases were heard together.

LORING, J. * * * Stripped of the surroundings which tend to obscure its real nature, the transaction in which the defendants took part was this: Gates and his four associates, and the defendants and their nine associates, believing that a tract of some 225,000 to 300,000 acres of land in Tennessee had natural resources which could be developed at a great profit, agreed to join themselves together to secure options on the land, and then organized a corporation which was to buy the options of them at a profit. This profit, after paying all actual expenses incurred in procuring the options and organizing the corporation, was to be divided equally between Gates and his associates, operating under the name of the Phœnix Land Company, and the defendants and their associates, operating as the Syndicate of Ten. In this joint adventure Gates and his associates contributed their information as to the land, and the defendants and their associates contributed the money ($15,000 to $30,000) to be advanced for the expenses of the enterprise, until the corporation to be organized was organized and was in funds, when these advances were to be repaid by

it. It was stated in the agreement providing for this joint adventure that the profit which they would secure from the corporation for the transfer of these options would be some $700,000; the cost of the lands being estimated to be $900,000, including $100,000 for expenses, and the value of the lands to the corporation being stated to be $1,500,-000. If the $100,000 of expenses included in the $900,000 were repaid to them, the difference between the two (that is to say, the net profit to the promoters of the corporation) would be $700,000. It was also agreed that "at least five-sixths of its net profits shall be taken by each of these two contracting parties in the stock of the new corporation."

The only particulars in which the promoters departed from this plan, in carrying it into effect, were that they organized the corporation when only one-third of the options contemplated had been secured, and that they then issued to themselves $700,000 of paid-up stock of the corporation, as the net profits which they were to make in the transaction. Nominally, this $700,000 of paid-up stock was issued in payment for options then owned by the Phœnix Land Company, on which it had paid $6,000, and the agreement of that company to secure further options, during a period of six months, at the expense of the new corporation. Really, this $700,000 of paid-up stock was issued to the promoters as remuneration for their services as promoters, or, as it is termed in the report of the superior court, for the net profits which it was arranged in the agreement between the Phœnix Land Company and the Syndicate of Ten should be divided equally between the two. The twenty-first finding of the superior court is explicit on this point. It is, so far as material here, as follows: "The sum named, $700,000, was not arrived at by any appraisal or attempted appraisal or valuation of any property, options, or contracts, or title bonds, etc., which the Phœnix Land Company had. * * * Said large sum was named as a consideration that it might be enough to include the 'profits' mentioned or contemplated in said paper marked 'No. 31,' and especially in clause 3 of the Plan More in Detail; and the shares received by all the said syndicate members and some others on July 3d were then really understood to be the profits or 'net profits' mentioned in the ninth clause of said paper marked 'No. 31,' and in the third and sixth clauses of the Plan More in Detail, annexed thereto, which by that agreement were to be divided between the ten syndicate members and the Phœnix Land Company; and this, also, was known to all the then stockholders of the East Tennessee Land Company, to wit, the thirteen directors of the East Tennessee Land Company and the officers of the Phœnix Land Company." The paper referred to in the report as paper marked "No. 31," and the Plan More in Detail, annexed thereto, make up the agreement between Gates and his associates and the defendants and their associates, which was finally completed on May 6, 1889.

The defendants rely in this connection upon two of the findings set forth in the report, namely, (1) that the vote authorizing the contract of June 11 was passed "and the contract executed by which the East Tennessee Land Company agreed to pay said $700,000 for the lands, options, contracts, and title bonds of the Phœnix Land Company, with

and upon the theory and belief——under advice of competent counsel practicing in Tennessee to that effect——that it would satisfy the laws of Tennessee, both as to the payment in of the capital of said corporation, and would, by orders of the Phœnix Land Company, be a proper way and method of settling for the shares of stock which each of the defendants and others subscribed for and got;" and (2), "I do not find that the defendants, or either of them, in signing the paper marked 'No. 31,' or in signing the subscription for stock on June 6th, and in becoming directors of the East Tennessee Land Company on June 10th, and in voting for the making of the contract with the Phœnix Land Company, and in taking, each, 250 shares of stock, intended any actual fraud, or intended to defraud or cheat either the corporation or the future stockholders or creditors of the East Tennessee Land Company. They did not anticipate the failure or insolvency of the company. Whatever those who originated the project expected, these defendants, when they became parties to it, believed (and, I think, not without some reason, with proper management) that it would succeed, and result in building up a prosperous town or city at Harriman." And the defendants contend that the stock issued to them was lawfully issued for interests in land and for services rendered or to be rendered; that under these findings there was no fraudulent overvaluation in the issuing of the $700,000 of shares of stock; that the issue of this stock was voted for by the defendants and others as stockholders, and that stockholders are under no fiduciary relation to anybody, and can do as they will with their own; and, moreover, that it was consented to by all the stockholders and incorporators of the East Tennessee Land Company, and consequently cannot now be made the basis of any complaint by the corporation or anybody else.

But this argument omits from the case the fact that the defendants, together with their associates in the Syndicate of Ten, and Gates, with his associates in the Phœnix Land Company, were promoters of the East Tennessee Land Company, and that these suits are instituted to charge them with secret profits made by them as such promoters, and not on the ground that the stock subscribed for by them has not been paid for under the laws of Tennessee. Whether it was or was not properly issued as paid-up stock, so far as a compliance with Tennessee statutes is concerned, is not material, and we express no opinion upon that point. See McKay's Case, 2 Ch.Div. 1, 6, 8. Moreover, it is not sought in these suits to charge the defendants because they voted, as stockholders, to issue the $700,000 of stock, but it is sought to charge each defendant because he, with others, was a promoter of the East Tennessee Land Company; because, as a promoter, he stood in a fiduciary relation to the future shareholders of that corporation, and by reason thereof he could not receive any remuneration for his services as a promoter of that corporation without making a full disclosure thereof, and obtaining the consent of these shareholders thereto. [Citing cases.]

If the fullest effect is given to the finding of the court that the defendants intended no actual fraud in taking 250 shares each, and did not intend to defraud or cheat either the corporation or the future stockholders or creditors of the East Tennessee Land Company, all

that the finding means is that the defendants honestly believed that the natural resources of the lands in question were so great that shares amounting to $700,000, par value, would be a fair remuneration to be paid to them and their associates for their services as promoters. But even if they did so believe, and their belief was honest, and there was a foundation for that honest belief, they none the less were guilty of a fraud. It is a fraud for promoters to undertake to decide for the future stockholders in the corporation to be organized that one-third of the whole capital stock of that corporation is a fair remuneration for their services as promoters, to issue one-third of the capital stock to themselves as such remuneration, and then to invite the public to subscribe to the stock of the corporation, without disclosing that fact to the subscribers, and without getting their consent to the payment of that remuneration.

The defendants say that they did disclose the fact to the East Tennessee Land Company, and that they did get the consent of the East Tennessee Land Company to the payment of this $700,000 of stock to them for their remuneration as promoters; and that is not only enough, but it is final. It is true that the vote authorizing the issue of this stock to them, as the profits which they were to have out of the organization of the company, was voted unanimously by all the incorporators of the East Tennessee Land Company, and all who were then subscribers to its capital stock; that is, by all the persons who then had any interest in that corporation. That is to say, it is true that the fact that the promoters were to receive $700,000 of paid-up capital stock as remuneration for their services was disclosed and consented to by all the persons who then had any interest in the corporation. But it is also true that at that time no person except the promoters had any interest in the corporation, barring one Mason, in whose name some of the options were subsequently taken, and who was plainly a mere nominee of the promoters, and that at that time no capital stock of the corporation had been issued to the public. Payment to promoters of remuneration for their services is not made valid by a vote passed by the corporation, when the corporation is in the sole control of the promoters, before the capital has been issued to the public. Phosphate Co. v. Erlanger, 5 Ch.Div. 73; Erlanger v. Phosphate Co., 3 App.Cas. 1218; In re Olympia [1898] 2 Ch.Div. 153; In re British Seamless Paper-Box Co., 17 Ch.Div. 467, 471, 472. The persons to whom the promoters owe the duty which they owe by reason of their fiduciary relation are the persons who put their money into the enterprise at the invitation of the promoters; that is to say, the future stockholders. It is to the future stockholders that the promoters must make the disclosure of the remuneration which is or is to be paid to them, and it is the consent of the future stockholders that must be obtained to make that payment valid; and if the promoters undertake to make to themselves remuneration for their services as promoters without making a full disclosure of the fact to the future stockholders, their principals, and getting their consent, they are guilty of a fraud. Promoters can make the necessary disclosure of the remuneration they stipulate for, by including in the prospectus a full statement thereof. If such a statement is not made therein,

they cannot honestly take any remuneration for promoters' services unless it is voted by the stockholders after all the stock has been taken by the public. * * *

* * * Upon substituting the East Tennessee Land Company as plaintiff in place of John K. Hayward, the causes are to stand for hearing as to what the net profits are, which the defendants have respectively received, or as to what the damages are, which the plaintiff has suffered, as the plaintiff shall elect to proceed for the property or its proceeds on the one hand, or for damages on the other hand.

Decree accordingly.[2]

OLD DOMINION COPPER MINING & SMELTING CO. v. BIGELOW.

Supreme Judicial Court of Massachusetts, Suffolk, 1905.
188 Mass. 315, 74 N.E. 653, 108 Am.St.Rep. 479.

Bill in equity, filed October 7, 1902.

The following statement of the case is taken from the opinion of the court:

This cause came on to be heard on two demurrers. The defendant filed a demurrer to the whole bill, and what purported to be a demurrer to so much of the bill "as seeks to have the sale of certain parcels of real estate conveyed to the plaintiff by Leonard Lewisohn rescinded, and to have the defendant ordered to return to the plaintiff the consideration paid by the plaintiff for said conveyance." On the plaintiff's stipulating that, in case the demurrers or either of them should be sustained on the merits, the bill, or so much thereof as the demurrers apply to, should be dismissed, the cause was reserved for the consideration of the full court.

The case stated in the bill, so far as material here, is, in effect and in substance, as follows: The defendant and one Lewisohn, at some time prior to March, 1895, formed the plan of buying the property of the Old Dominion Copper Company, of the city of Baltimore (hereinafter spoken of as the "Baltimore Company"), and four certain mining claims and a mill site standing in the name of one Keyser (hereinafter spoken of as the "real estate here in question"), with a view to reselling them at a profit to a corporation to be organized by them for that purpose. Their scheme was first to buy all the stock of the Baltimore Company. Having got control of that company through their ownership of all of its capital stock, they were to organize a new company, and before the stock of the new company was issued, and while it was entirely in their control as the organizers of it, they were to sell to it the property of the Baltimore Company and the real estate here in

[2] The corporation was substituted as plaintiff; defendant attempted unsuccessfully to interpose the defense of the statute of limitations, East Tennessee Land Co. v. Leeson, Same v. Hopewell, 178 Mass. 206, 59 N.E. 639, 1901. Defendants then appealed from the affirmance of the master's report awarding damages to plaintiff. This decree was aff'd, 183 Mass. 37, 66 N.E. 427, 1903; appeal from this order aff'd, 185 Mass. 4, 69 N.E. 351, 1904.

Little, Promoters' Frauds in the Organization of Corporations: The Old Dominion Copper Mining Cases, 1910, 5 Ill.L.Rev. 87, 102; Note, 1933, 85 A.L.R. 1262, 1280.

question for a specified number of shares of the new company, the balance of shares in the capital stock of the new company being sold to the public to provide working capital and to build additions. All this was done. The plaintiff was the new corporation. The defendant and Lewisohn got the money with which to buy all shares in the capital stock of the Baltimore Company from a syndicate (hereinafter called the "Dominion Syndicate") which they organized for the purpose, and to which they agreed to pay two dollars for every dollar paid into the syndicate treasury in case the scheme was a success, with a privilege given to the syndicate members of taking shares at par in the new corporation in place of money. Five-sevenths of the stock of the Baltimore Company were bought of the executors of one Simpson for a sum not more than $613,137.39, and the other two-sevenths, together with the real estate here in question, of one Keyser, and "other persons to the plaintiff unknown," for a sum not exceeding $175,182.11; and thereupon the real estate here in question was conveyed to Lewisohn. These transactions were carried through on July 8, 1895. On the same 8th day of July, 1895, the plaintiff corporation was organized by seven persons employed by the defendant and Lewisohn for the purpose, apparently with a capital stock of $1,000, divided into 40 shares of $25 each, which were issued to the incorporators, but were in fact paid for by the defendant and Lewisohn. On July 9, 1895, the incorporators met, chose themselves directors, and increased the authorized capital stock to $3,750,000, composed of 150,000 shares of $25 each. At a meeting of the directors held on July 11, 1895, pursuant to instructions from the defendant, five directors resigned, and the defendant and Lewisohn, together with three members of the Dominion Syndicate, were appointed in their places. Thereupon the defendant and Lewisohn took their seats on the board. The other three new directors were not present. After these changes in the directorate, the directors present at the meeting were the defendant, Lewisohn, one Evarts, "the attorney employed by said defendant and said Leonard Lewisohn to attend to the incorporation of the plaintiff corporation and to carry out their said plan and conspiracy," and one Buffum, a person "selected" and "employed" by the defendant and Lewisohn "to act as director and assist them in carrying out said plan and conspiracy." Thereupon the defendant, through said Evarts, presented to the board an offer to sell to the plaintiff corporation the property of the Baltimore Company for 100,000 shares in its capital stock, and Lewisohn offered to sell to the plaintiff corporation the real estate here in question for 30,000 shares in its capital stock. These offers were accepted, and the stock was in fact subsequently issued in accordance therewith. Of the 30,000 shares issued for the real estate here in question, the defendant received 16,410 and Lewisohn 13,590. Of the 100,000 shares issued for the property of the Baltimore Company, 80,000 were issued to the syndicate, and the other 20,000 were issued to the defendant and Lewisohn for their expenses and services. Of this 20,000, the defendant received 10,940 and Lewisohn 9,060. It is alleged that at this time the fair market value of the shares in the capital stock of the plaintiff corporation was par, and "continued for a long time thereafter to be of such or greater value."

The bill goes on to allege that no disclosure was made of the profit made by the issue of the 30,000 shares for the real estate here in question to the persons who subscribed for the 20,000 shares issued for working capital, or to the members of the syndicate to which the 80,000 shares were issued (except to the defendant and Lewisohn, members thereof). It is alleged also that from July 11, 1895, to July 4, 1902, the plaintiff corporation was in effect in the control of the defendant and Lewisohn. Thereafter investigations were begun which resulted in the filing of this bill on October 7, 1902. It is alleged, further, that Lewisohn died March 5, 1902, and at the time of his death was a resident and citizen of the city of New York; that the executors of his will are also residents and citizens of the city of New York; that no executors or legal representatives have been appointed or are within this commonwealth; that there is no property within the commonwealth belonging to said estate; and that it is impossible to get service within this commonwealth on the executors of the will of Lewisohn. It is also alleged that the real estate here in question, at the time of the sale to the plaintiff, was "of substantially no value, to wit, of a value not exceeding five thousand ($5,000) dollars, and * * * [was] * * * known by said Lewisohn and by the defendant, when" they acquired the same, and when they offered to sell the same to the plaintiff, "to be of substantially no value"; and that said "property has since said conveyance remained undeveloped, and is now in substantially the same condition that it was in at the time of the conveyance" to the plaintiff.

The plaintiff alleges that it "desires to rescind the sale" of said real estate, "and has offered to convey" it "to the defendant, or to such person as he may request, upon receiving from said defendant" said 30,000 shares, "or, if and in so far as said shares have been disposed of, upon the defendant's duly accounting therefor; but said defendant refused to make any such restitution or accounting." After alleging a continued readiness to convey, the bill concludes with a prayer that the court will declare the sale of the mining claims and of the mill site rescinded, and will direct the defendant to return the 30,000 shares, or, if and in so far as said shares are no longer in his control, to account to the plaintiff therefor, or, in the alternative, in case it is held that the sale is not rescinded and that the plaintiff is not entitled to rescind that sale, for damages. There is also a prayer for general relief.

It was stated at the bar that another bill had been brought for relief in respect of the issue of the 100,000 shares, and that the only relief here sought was in respect of the 30,000 shares issued in payment for the real estate here in question.

The result of these transactions was that, for the property for which the defendant and Lewisohn had paid not more than $788,319.50, the plaintiff corporation issued 130,000 shares of its capital stock, having a market value of at least $3,250,000—a profit of at least $2,460,000. Of these 130,000 shares, 80,000 (which were worth at least $2,000,000) went to the syndicate, 20,000 (worth at least $500,000) went to the defendant and Lewisohn for services and expenses, 30,000 (worth at least $750,000) went to the defendant and Lewisohn for the

real estate here in question, and the balance, 20,000, to the public (apparently with the exception of the original 40 shares issued to the incorporators and paid for by the defendant and Lewisohn).

LORING, J. (After the foregoing statement of the case). The only question now before us is whether the plaintiff is entitled to any relief on these facts. If it is, it is not necessary to determine what the relief is to which it is entitled. An attempt has been made to force a decision on the nature of the relief at this time by demurring "to so much of said bill as seeks to have the sale of certain parcels of real estate conveyed to the plaintiff by Leonard Lewisohn rescinded, and to have the defendant ordered to return to the plaintiff the consideration paid by the plaintiff for said conveyance." But there is no part of the bill which seeks rescission. This demurrer is not a demurrer to a part of the bill; it is to the whole bill so far as it seeks rescission. This so-called "demurrer to a part" is in fact an assignment of causes of demurrer to the whole bill, and will be so treated.

The defendant has contended that on the facts stated in the bill no case is made out for relief in respect of the 30,000 shares issued for the four mining claims and the mill site.

It will be useful to get a clear conception of what is and what is not alleged in the bill, and of the rights of the parties in such a transaction as that here set forth.

It was settled by the recent case of Hayward v. Leeson, 176 Mass. 310, 57 N.E. 656, 49 L.R.A. 725, that a promoter of a corporation stands in a fiduciary relation to the corporation of which he is a promoter.

It is clear that on the facts stated the defendant was a promoter of the plaintiff corporation.

It is not alleged here that the defendant made any misrepresentations as to the price paid by himself and Lewisohn for the property resold to the plaintiff at an advance, as was the case in Gluckstein v. Barnes [1900] A.C. 240; s.c. below, sub nomine In re Olympia Limited [1898] 2 Ch. 153; Hichens v. Congreve, 4 Sim. 420. Where one standing in a fiduciary relation makes such a misrepresentation, it may well be that the purchaser can keep the property and force the vendor to make good the representation, and pay to him, the purchaser, the difference between what was in fact paid by the vendor and what he represented that he paid for it.

Further, the defendant is not liable here on the ground that the plaintiff corporation is entitled to the benefit of the original purchase of the real estate here in question, as a beneficiary is entitled where a person standing to him in a fiduciary capacity buys for himself and resells to him, the beneficiary, at a profit, when he ought originally to have bought for the beneficiary. In such a case the purchaser can keep the property and charge the defendant with the difference in price. Parker v. Nickerson, 137 Mass. 487, 497.

When the defendant and Lewisohn bought this real estate, they were under no obligation to make the purchase of it for the plaintiff corporation, which was not then in existence. Having bought the property at that time and paid for it with what, as between them and

the plaintiff corporation, was their own money, they could have kept it or resold it to the plaintiff corporation or to anybody else, as they saw fit. The fact that the property was bought with a view to reselling it to a corporation to be organized for the purpose, and that that purpose was ultimately carried into effect, does not give to the corporation subsequently organized in execution of the original purpose a right to the benefit of the purchase. That was considered in New Sombrero Co. v. Erlanger, 5 Ch.D. 73, 118, 119, and at still greater length in that case on appeal, Erlanger v. New Sombrero Co., 3 App. Cas.1218, by Lord Hatherley at page 1242, Lord O'Hagan at page 1255, and Lord Blackburn at pages 1267 and 1268. It is enough to say that we agree with what is there said. For a case where no relief was given because it was not made out that this company was entitled to the benefit of the original purchase, see Ladywell Mining Co. v. Brookes, 35 Ch.D. 400.

The situation, then, was this: The defendant and Lewisohn were, so far as this case goes, the absolute owners of the four mining claims and the mill site. We say the absolute owners so far as this case is concerned, because the rights of the Dominion Syndicate in this real estate, if any, are not here in question, and therefore, so far as this case is concerned, their rights may be disregarded. Being the absolute owners of it, the defendant and Lewisohn could do with that property as they pleased—let it lie idle, work it, or sell it, as they thought best; and, if they determined to sell it, they could sell it to any one they chose. If they chose to sell it to a stranger, they could make the sale at arm's length, ask any price they pleased and were under no legal obligation to state what it had cost them. On the other hand, if they elected to make a sale of it to one standing to them in a fiduciary relation, they were under an obligation to make a full disclosure to the beneficiary of all facts known to them material to the property and the purchase, or see to it that the fiduciary had adequate independent advice. That is an obligation resting upon every fiduciary who makes a sale of his own property to his beneficiary, no matter whether it is a case of trustee and cestui que trust, guardian and ward, solicitor and client, or promoter of a corporation and the corporation itself.

There is no pretense that in the transaction in question the plaintiff corporation was represented by an independent board.

The defendant has sought in the first place to distinguish the case at bar from Hayward v. Leeson, 176 Mass. 310, 57 N.E. 656, 49 L.R.A. 725, on the ground that in the prospectus in that case there was the false statement that the capital stock represented actual value, without inflation, while a substantial part of it had been issued to the defendants and their associates for nominal services. But that fact was not spoken of in the opinion as the ground of the decision. The opinion went on the broad ground mentioned above. This false representation was spoken of in connection with a contention on the part of those defendants that they were not liable because of a finding made by the superior court that the defendants did not conceal the transaction from the knowledge of future stockholders. The case of New Sombrero Co. v. Erlanger, 5 Ch.D. 73; s.c. on appeal, Erlanger v. New

Sombero Co., 3 App.Cas. 1218—is on all fours with the case at bar in this respect. In that case there was no misrepresentation.

In the second place, the defendant contends that the corporation cannot complain because the facts were known to the four directors who took part in the purchase, and to the holders of all shares of capital stock of the corporation outstanding when the contract of purchase here in question was made, and that purchase was acquiesced in by them. They contend that this result follows because one buying shares from a shareholder who acquiesces is bound by the acquiescence of his vendor. The four directors present at the directors' meeting when the real estate in question was sold by the defendant and Lewisohn to the plaintiff corporation for 30,000 shares were the defendant and Lewisohn, their attorney, and one Buffum, "a person selected by them and employed by them to act as director and assist them in carrying out said plan and conspiracy." On the allegations of the bill, the defendant and Lewisohn are to be treated as the owners of all the shares then outstanding, and therefore the transaction is to be taken to have been known to and acquiesced in by all the then stockholders.

It is proper to pause here and see just what this contention means. When this contract was made on July 11, 1895, the authorized capital stock had just been increased from 40 shares to 150,000 shares of $25 each; that is to say, from $1,000 to $3,750,000. Of the authorized capital stock only 40 shares, or $1,000, had then been issued. As we have said, these 40 shares are to be treated on the allegations of the bill as the property of the defendant and Lewisohn. The scheme of the defendant and Lewisohn as to this capital stock of $3,750,000, divided into 150,000 shares, was to issue 80,000 shares (or $2,000,000) to the syndicate, or sell them to the public for cash to provide $2,000,000 to be paid to the syndicate; 20,000 shares (or $500,000) to themselves for their services and expenses as promoters; 20,000 shares (or $500,000) to the public for cash for working capital; and the balance, 30,000 shares (or $750,000), to themselves for the real estate here in question. And this scheme was carried out; and, in carrying it out, no disclosure was made to the persons who took the syndicate's 80,000 shares (except those of the 80,000 issued to the defendant and Lewisohn as members of the syndicate), nor to those who took the 20,000 shares sold to the public for cash for working capital. Of the 80,000 issued for the syndicate, it is alleged that the defendant received 4,000. It is not alleged that any of this 80,000 were issued to Lewisohn. The contention is that, inasmuch as the defendant and Lewisohn owned all the 40 shares of the corporation, amounting to $1,000, outstanding when the sale here in question was made by them to the corporation, the corporation is barred from complaining that a full disclosure of the material facts was not made by them to it. * * *

The case submitted to us for decision here by the defendant's demurrer to this bill is a case where (disregarding the 40 shares subscribed for to organize the corporation) the whole capital stock was 150,000 shares, of which 54,000 shares were to be issued to the promoters for services and for the sale of the land here in question, and

the remaining 96,000 were to be issued to persons to whom the facts of this sale were not disclosed.

The question arises whether in such a case the rule enforced in Hayward v. Leeson, 176 Mass. 310, 57 N.E. 656, 49 L.R.A. 725, applies.

In Hayward v. Leeson it was held by this court that a corporation was not barred in the recovery of secret profits made by promoters by the fact that the promoters owned all the stock of the corporation when the agreement was made to pay them the profits recovered in that case. The secret profits agreed upon paid and recovered in that case were paid up shares of capital stock of the par value of $750,000 for services as promoters out of a capital of $3,000,000, the rest of which was subscribed to and paid for by the public in cash. To the cases cited in Hayward v. Lesson on this point, 176 Mass., at page 320, 57 N.E. 660, 49 L.R.A. 725, should be added Gluckstein v. Barnes [1900] A.C. 240, the decision of the House of Lords on appeal from In re Olympia, Limited [1898] 2 Ch. 153, made after the opinion in Hayward v. Leeson was written.

The question which we have to decide here is whether the difference in the way in which this transaction was carried through leads to the opposite result. If in the case at bar the 96,000 shares not issued to the promoters had been offered to the public for cash to be used in buying the property of the old Baltimore Company and for working capital, and had been taken by them, the case at bar would have come directly within the decision in Hayward v. Leeson.

We see no reason why the rule enforced in Hayward v. Leeson does not apply to the case stated in the bill now before us.

The defendant has insisted that the corporation is barred in this case because, if it (the corporation) is allowed to recover in such a suit, the purchasers of the 54,000 shares issued to the defendant and Lewisohn would get their share of the sum recovered, and to that extent the purchaser of these shares would not be bound by the acquiescence of their vendors. That is true. That was true in Hayward v. Leeson. In that case the purchasers of the 750,000 shares would have got their share of the sums recovered by the receiver in behalf of the corporation if there was any left after the debts were paid. The argument is an old one, and was disposed of by Lord Justice James in New Sombrero Co. v. Erlanger, 5 Ch.D. 73, 115, 116. A corporation is not precluded from recovering for a fraud on it (the corporation) because the party committing the fraud is a stockholder.

Again, the corportaion is not barred because, when the agreement was made, it acquiesced in the trade, and it was then, from a legal point of view, fully born. That was equally true in Hayward v. Leeson and the cases cited in that case. The answer to the suggestion is that from a business point of view the agreement was not made to bind the corporation with a capital of $1,000, which was the corporation then in fact in existence, but to bind the corporation with a capital of $3,750,000. It was to that corporation, with a capital of $3,750,000, that a full disclosure ought to have been made, and to that corporation no disclosure was ever made.

In the case stated in this bill the defendant was a promoter of the plaintiff corporation; being a promoter, he stood in a fiduciary rela-

tion to it; on selling to the plaintiff the real estate here in question he was bound to disclose all facts known to him material in the sale, since it was not independently represented; the price at which the property had been recently bought with a view to reselling it to the plaintiff corporation was at any rate a material fact which he was bound to disclose; the knowledge of the defendant and Lewisohn was not a disclosure to the plaintiff, although they owned all the stock of the plaintiff corporation outstanding at the time the sale was made; and, although 56,000 out of 150,000 shares of the capital stock ultimately issued was issued to them, the defendant violated the duty which he owed the plaintiff in not disclosing that fact; and for this reason the contract here in question was not binding on the plaintiff.

On the facts stated, the property sold having remained unchanged, the contract came to an end on the plaintiff's electing to rescind and tendering a reconveyance of it back to the defendant. * * *

The so-called demurrer as to part of the bill shall stand as an assignment of a cause of a demurrer; demurrer overruled.[3]

OLD DOMINION COPPER MINING & SMELTING COMPANY v. LEWISOHN et al.

Supreme Court of the United States 1908. 210 U.S. 206, 28 S.Ct. 634, 52 L.Ed. 1025.

Certiorari to the United State Circuit Court of Appeals for the Second Circuit to review a decree of the Circuit Court for the Southern District of New York, sustaining a demurrer to, and dismissing a bill brought by a corporation to rescind a sale of property to it by its promoters.

MR. JUSTICE HOLMES delivered the opinion of the court:

This is a bill in equity brought by the petitioner to rescind a sale to it of certain mining rights and land by the defendants' testator, or, in the alternative, to recover damages for the sale. The bill was demurred to and the demurrer was sustained. 136 F. 915. Then the bill was amended and again demurred to, and again the demurrer was sustained, and the bill was dismissed. This decree was affirmed by the circuit court of appeals. 79 C.C.A. 534, 148 F. 1020. The ground of the petitioner's case is that Lewisohn, the deceased, and one Bigelow, as promoters, informed the petitioner that they might sell certain properties to it at a profit; that they made their sale while they owned all the stock issued, but in contemplation of a large further issue to the public without disclosure of their profit, and that such an issue in fact was made. The supreme judicial court of Massachusetts has held the plaintiff entitled to recover from Bigelow upon a

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3 The cause was heard on the merits, and judgment rendered for plaintiff, 203 Mass. 159, 89 N.E. 193, 40 L.R.A.,N.S., 314, 1909; aff'd 225 U.S. 111, 32 S.Ct. 641, 56 L.Ed. 1009, Ann.Cas.1913E 875, 1912. For a history of this litigation and discussion of the principles involved, see Note, 1935, 83 A.L.R. 1262, 1283–1289. See Isaacs, The Promoter: A Legislative Problem, (1925) 38 Harv.L.Rev. 887.

Weston, Promoters' Liability: Old Dominion v. Bigelow, 1916, 30 Harv.L.Rev. 39 (a criticism of the rule laid down in this case); Note, 1910, 58 U. of Pa.L.Rev. 226; 1909, 23 Harv.L.Rev. 147.

substantially similar bill. 188 Mass. 315, 108 Am.St.Rep. 479, 74 N.E. 653.

The facts alleged are as follows: The property embraced in the plan was the mining property of the Old Dominion Copper Company of Baltimore, and also the mining rights and land now in question, the latter being held by one Keyser, for the benefit of himself and of the executors of one Simpson, who, with Keyser, owned the stock of the Baltimore company. Bigelow and Lewisohn, in May, and June, 1895, obtained options from Simpson's executors and Keyser for the purchase of the stock and the property now in question. They also formed a syndicate to carry out their plan, with the agreement that the money subscribed by the members should be used for the purchase and the sale to a new corporation, at a large advance, and that the members, in the proportion of their subscriptions, should receive in cash or in stock of the new corporation the profit made by the sale. On May 28, 1895, Bigelow paid Simpson's executors for their stock on behalf of the syndicate, in cash and notes of himself and Lewisohn, and in June Keyser was paid in the same way.

On July 8, 1895, Bigelow and Lewisohn started the plaintiff corporation, the seven members being their nominees and tools. The next day the stock of the company was increased to 150,000 shares of $25 each, officers were elected, and the corporation became duly organized. July 11, pursuant to instructions, some of the officers resigned, and Bigelow and Lewisohn and three other absent members of the syndicate came in. Thereupon an offer was received from the Baltimore company, the stock of which had been bought, as stated, by Bigelow and Lewisohn, to sell substantially all its property for 100,000 shares of the plaintiff company. The offer was accepted, and then Lewisohn offered to sell the real estate now in question, obtained from Keyser, for 30,000 shares, to be issued to Bigelow and himself. This also was accepted and possession of all the mining property was delivered the next day. The sales "were consummated" by delivery of deeds, and afterwards, on July 18, to raise working capital, it was voted to offer the remaining 20,000 shares to the public at par, and they were taken by subscribers who did not know of the profit made by Bigelow and Lewisohn and the syndicate. On September 18 the 100,000 and 30,000 shares were issued, and it was voted to issue the 20,000 when paid for. The bill alleges that the property of the Baltimore company was not worth more than $1,000,000, the sum paid for its stock, and the property here concerned not over $5,000, as Bigelow and Lewisohn knew. The market value of the petitioner's stock was not less than par, so that the price paid was $2,500,000, it is said, for the Baltimore company's property, and $750,000 for that here concerned. Whether this view of the price paid is correct, it is unnecessary to decide.

Of the stock in the petitioner, received by Bigelow and Lewisohn of their Baltimore corporation 40,000 shares went to the syndicate as profit, and the members had their choice of receiving a like additional number of shares or the repayment of their original subscription. As pretty nearly all took the stock, the syndicate received about 80,000 shares. The remaining 20,000 of the stock paid to the Balti-

more company, Bigelow and Lewisohn divided, the plaintiff believes, without the knowledge of the syndicate. The 30,000 shares received for the property now in question they also divided. Thus the plans of Bigelow and Lewisohn were carried out.

The argument for the petitioner is that all would admit that the promoters (assuming the English phrase to be well applied) stood in a fiduciary relation to it, if, when the transaction took place, there were members who were not informed of the profits made and who did not acquiesce, and that the same obligation of good faith extends down to the time of the later subscriptions, which it was the promoters' plan to obtain. It is an argument that has commanded the assent of at least one court, and is stated at length in the decision. But the courts do not agree. There is no authority binding upon us and in point. The general observations in Dickerman v. Northern Trust Co., 176 U.S. 181, 44 L.Ed. 423, 20 S.Ct. 311, were obiter, and do not dispose of the case. Without spending time upon the many dicta that were quoted to us, we shall endeavor to weigh the considerations on one side and the other afresh.

The difficulty that meets the petitioner at the outset is that it has assented to the transaction with the full knowledge of the facts. It is said, to be sure, that on September 18, when the shares were issued to the sellers, there were already subscribers to the 20,000 shares that the public took. But this does not appear from the bill, unless it should be inferred from the ambiguous statement that on that day it was voted to issue those shares "to persons who had subscribed therefor," upon receiving payment, and that the shares "were thereafter duly issued to said persons," etc. The words "had subscribed" may refer to the time of issue and be equivalent to "should have subscribed," or may refer to an already past event. But that hardly matters. The contract had been made and the property delivered on July 11 and 12, when Bigelow, Lewisohn, and some other members of the syndicate held all the outstanding stock, and it is alleged in terms that the sales were consummated before the vote of July 18, to offer stock to the public, had been passed.

At the time of the sale to the plaintiff, then, there was no wrong done to anyone. Bigelow, Lewisohn, and their syndicate were on both sides of the bargain, and they might issue to themselves as much stock in their corporation as they liked in exchange for their conveyance of their land. Salomon v. A. Salomon & Co. [1897] A.C. 22; Blum v. Whitney, 185 N.Y. 232, 77 N.E. 1159; Tompkins v. Sperry, 96 Md. 560, 54 A. 254. If there was a wrong, it was when the innocent public subscribed. But what one would expect to find, if a wrong happened then, would not be that the sale became a breach of duty to the corporation nunc pro tunc, but that the invitation to the public without disclosure, when acted upon, became a fraud upon the subscribers from an equitable point of view, accompanied by what they might treat as damage. For it is only by virtue of the innocent subscribers' position and the promoter's invitation that the corporation has any pretense for a standing in court. If the promoters, after starting their scheme, had sold their stock before any subscriptions were taken, and then the purchasers of their stock, with notice, had invited the public

to come in, and it did, we do not see how the company could maintain this suit. If it could not then, we do not see how it can now.

But it is said that from a business point of view, the agreement was not made merely to bind the corporation, as it then was, with only 40 shares issued, but to bind the corporation when it should have a capital of $3,750,000; and the implication is that practically this was a new and different corporation. Of course, legally speaking, a corporation does not change its identity by adding a cubit to its stature. The nominal capital of the corporation was the same when the contract was made and after the public had subscribed. Therefore, what must be meant is, as we have said, that the corporation got a new right from the fact that new men, who did not know what it had done, had put in their money and had become members. It is assumed in argument that the new members had no ground for a suit in their own names, but it is assumed also that their position changed that of the corporation, and thus that the indirect effect of their acts was greater than the direct; that facts that gave them no claim gave one to the corporation because of them, notwithstanding its assent. We shall not consider whether the new members had a personal claim of any kind, and therefore we deal with the case without prejudice to that question, and without taking advantage of what we understand the petitioner to concede.

But, if we are to leave technical law on one side, and approach the case from what is supposed to be a business point of view, there are new matters to be taken into account. If the corporation recovers, all the stockholders, guilty as well as innocent, get the benefit. It is answered that the corporation is not precluded from recovering for a fraud upon it, because the party committing the fraud is a stockholder. Old Dominion Copper Min. & Smelting Co. v. Bigelow, 188 Mass. 315, 327, 108 Am.St.Rep. 479, 74 N.E. 653. If there had been innocent members at the time of the sale, the fact that there were also guilty ones would not prevent a recovery, and even might not be a sufficient reason for requiring all the guilty members to be joined as defendants in order to avoid a manifest injustice. Stockton v. Anderson, 40 N.J.Eq. 486, 4 A. 642. The same principle is thought to apply when innocent members are brought in later under a scheme. But it is obvious that this answer falls back upon the technical diversity between the corporation and its members, which the business point of view is supposed to transcend, as it must, in order to avoid the objection that the corporation has assented to the sale with full notice of the facts. It is mainly on this diversity that the answer to the objection of injustice is based in New Sombrero Phosphate Co. v. Erlanger, L.R. 5 Ch.Div. 73, 114, 122.

Let us look at the business aspect alone. The syndicate was a party to the scheme to make a profit out of the corporation. Whether or not there was a subordinate fraud committed by Bigelow and Lewisohn on the agreement with them, as the petitioner believes, is immaterial to the corporation. The issue of the stock was apparent, we presume, on the books, so that it is difficult to suppose that at least some members of the syndicate, representing an adverse interest, did not know what was done. But all the members were engaged in the plan of buy-

ing for less and selling to the corporation for more, and were subject to whatever equity the corporation has against Bigelow and the estate of Lewisohn. There was some argument to the contrary, but this seems to us the fair meaning of the bill. Bigelow and Lewisohn, it is true, divided the stock received for the real estate now in question. But that was a matter between them and the syndicate. The real estate was bought from Keyser by the syndicate, along with his stock in the Baltimore company, and was sold by the syndicate to the petitioner, along with the Baltimore company's property, as part of the scheme. The syndicate was paid for it, whoever received the stock. And this means that 2/15 of the stock of the corporation, the 20,000 shares sold to the public, are to be allowed to use the name of the corporation to assert rights against Lewisohn's estate that will inure to the benefit of 13/15 of the stock that are totally without claim. It seems to us that the practical objection is as strong as that arising if we adhere to the law.

Let us take the business point of view for a monent longer. To the lay mind it would make little or no difference whether the 20,000 shares sold to the public were sold on an original subscription to the articles of incorporation or were issued under the scheme to some of the syndicate and sold by them. Yet it is admitted, in accordance with the decisions, that in the latter case, the innocent purchasers would have no claim against anyone. If we are to seek what is called substantial justice, in disregard of even peremptory rules of law, it would seem desirable to get a rule that would cover both of the almost equally possible cases of what is deemed a wrong. It might be said that if the stock really was taken as a preliminary to selling to the public, the subscribers would show a certain confidence in the enterprise, and give at least that security for good faith. But the syndicate believed in the enterprise, notwithstanding all the profits that they made it pay. They preferred to take stock at par rather than cash. Moreover, it would have been possible to issue the whole stock in payment for the property purchased, with an understanding as to 20,000 shares.

Of course, it is competent for legislators, but not, we think, for judges, except by a quasi legislative declaration, to establish that a corporation shall not be bound by its assent in a transaction of this kind, when the parties contemplate an invitation to the public to come in and join as original subscribers for any portion of the shares. It may be said that the corporation cannot be bound until the contemplated adverse interest is represented, or it may be said that promoters cannot strip themselves of the character of trustees until that moment. But it seems to us a strictly legislative determination. It is difficult, without inventing new and qualifying established doctrines, to go behind the fact that the corporation remains one and the same after once it really exists. When, as here, after it really exists, it consents, we at least shall require stronger equities than are shown by this bill to allow it to renew its claim at a later date because its internal constitution has changed.

To sum up: In our opinion, on the one hand, the plaintiff cannot recover without departing from the fundamental conception embodied in the law that created it,—the conception that a corporation

remains unchanged and unaffected in its identity by changes in its members. Donnell v. Herring-Hall-Marvin Safe Co., 208 U.S. 267, 273, ante, 288, 28 S.Ct. 288; Salomon v. A. Salomon & Co. [1897] A.C. 22, 30. On the other hand, if we should undertake to look through fiction to facts, it appears to us that substantial justice would not be accomplished, but rather a great injustice done, if the corporation were allowed to disregard its previous assent in order to charge a single member with the whole results of a transaction to which 13/15 of its stock were parties, for the benefit of the guilty, if there was guilt in anyone, and the innocent alike. We decide only what is necessary. We express no opinion as to whether the defendant properly is called a promoter, or whether the plaintiff has not been guilty of laches, or whether a remedy can be had for a part of a single transaction in the form in which it is sought, or whether there was any personal claim on the part of the innocent subscribers, or as to any other question than that which we have discussed.

The English case chiefly relied upon, Erlanger v. Now Sombrero Phosphate Co., L.R. 3 App.Cas. 1218, affirming L.R. 5 Ch.Div. 73, seems to us far from establishing a different doctrine for that jurisdiction. There, to be sure, a syndicate had made an agreement to sell, at a profit, to a company to be got up by the sellers. But the company, at the first stage, was made up mainly of outsiders, some of them instruments of the sellers, but innocent instruments, and, according to Lord Cairns, the contract was provisional on the shares being taken and the company formed. (P. 1239.) There never was a moment when the company had assented with knowledge of the facts. The shares, with perhaps one exception, all were taken by subscribers ignorant of the facts (L.R. 5 Ch.Div. 113), and the contract seems to have reached forward to the moment when they subscribed. As it is put in 2 Morawetz, Priv.Corp. 2d ed. § 292, there was really no company till the shares were issued. Here, 13/15 of the stock had been taken by the syndicate, the corporation was in full life, and had assented to the sale with knowledge of the facts before an outsider joined. There, most of the syndicate were strangers to the corporation, yet all were joined as defendants. (P. 1222.) Here, the members of the syndicate, although members of the corporation, are not joined, and it is sought to throw the burden of their act upon a single one. Gluckstein v. Barnes [1900] A.C. 240, certainly is no stronger for the plaintiff, and in Yeiser v. United States Board & Paper Co., 52 L.R.A. 724, 46 C.C.A. 567, 107 Fed. 340, another case that was relied upon, the transaction equally was carried through after innocent subscribers had paid for stock.

Decree affirmed.[4]

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[4] Little, Promoters' Frauds in the Organization of Corporations: Old Dominion Copper Mining Cases, 1910, 5 Ill.L.Rev. 87; Notes, 1908, 8 Col.L.Rev. 567; 1908, 22 Harv.L.Rev. 48; 1908, 22 Harv.L.Rev. 58.

On the liability of promoters to the corporation or its stockholders for secret profits, see: Brockelbank, The Compensation of Promoters, 1934, 13 Ore.L.Rev. 195, 204–221; Spurrier, Rights of a Corporation in Missouri Against Promoters for Secret Profits 1936, 1 Mo.L.Rev. 161; Tajonera, Corporate Right of Action for Promoters' Fraud, 1938, 17 Phil.L.J. 49; Notes, 1933, 85 A.L.R. 1262, 1934, 22 Calif.L. Rev. 326, 1926, 26 Col.L.Rev. 447, 1936, 31 Ill.L.Rev. 392; Measure of Recovery Against A Promoter Who Sells Property to a Corporation in Breach of Fiduciary Duty, 1940, 7 U. of Chi.L.Rev. 534, 1929, 77 U. of Pa.L.Rev. 661, 1937, 12 Wash.L.Rev.

NOTE

(A) A corporation may recover secret profits made by some of its promoters and cause the stock issued to them for their services to be surrendered for cancellation, where there were innocent and deceived promoter-subscribers, at the time the property was taken over by the corporation. Davis v. Las Ovas Company, 227 U.S. 80, 33 S.Ct. 197, 57 L.Ed. 426, 1913.

(B) Secret profits are frequently made by the disposal of stock which the promoter receives in exchange for property sold to the corporation at an excessive valuation and without full disclosure to the interested parties. Now, what if this stock for some reason be invalid or void?" Note, 1923, 23 Col.L.Rev. 476, 477.

(C) There has been a radical difference of opinion as to the promoter's liability to a suit brought by the corporation if his transfer was made when the corporation is composed of the promoters or of shareholders entirely conversant with the transaction. The Supreme Court has refused to permit recovery by the corporation even where the fraudulent intention of bringing in new shareholders existed, provided full disclosure was made to all members of the corporation at the time of the transaction. On the same transaction, however, the Massachusetts court held one of the promoters concerned liable to suit by the corporation to recover secret profits. There is no conflict, however, if any existing shareholders or subscribers are kept in ignorance of the profit or prospective profit and disclosure is made only to the promotion group in control.

In Davis v. Las Ovas Co., Inc., it was held by the Supreme Court that there is a right of action in the corporation itself against promoters guilty of fraud, if there are at the time any innocent shareholders or subscribers who are ignorant of the scheme to make a secret profit. "The standing of the corporation results from the fact that there were innocent and deceived members of the corporation when the property was taken over by it." Recovery by the corporation is not defeated by the fact that it will inure to the benefit of the guilty as well as the innocent members. This decision, and the more recent McCandless case, have greatly weakened the authority of the Lewisohn case. The *reductio ad absurdum* of that famous case is seen in an Arizona decision, that a single deceived shareholder, although he may have sold his shares subsequent to the transaction, is sufficient to satisfy the requirements of a corporate right of action. These requirements have also been satisfied by the existence of "equitable shareholders," where the outside deceived parties have merely subscribed or agreed to take shares from the corporation. The deceived subscribers are regarded as real parties in interest. It is said that to the extent that they were injured, "it was an injury to the corporation as representing their collective or corporate interests."

The fallacy underlying Justice Holmes' opinion in the Lewisohn case seems to lie in the assumption that the sole duty of the promoter is toward the few insiders who may for the moment constitute the company, and that disclosure to them of a purchase at an exorbitant price in money or shares will suffice to bind the corporation, when the whole point of the scheme is that the profit shall be obtained from the money to be derived from incoming investors on a fraudulent set-up. * * *

It was held by the United States Supreme Court, as we have seen, in Old Dominion Copper Mining & Smelting Co. v. Lewisohn, that no right of action arises in favor of the corporation on these facts. This view has been followed by some state courts. The doctrine of Justice Holmes was briefly that as the only existing shareholders, the promoter and his associates, assented to their own profit with

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30; 1925, 13 Calif.L.Rev. 240; 1894, 7 Harv.L.Rev. 434; 1910, 23 Harv.L.Rev. 566; 1941, 19 Tex.L.Rev. 198; 1924, 31 W.Va.L.Q. 67; 1926, 3 Wis.L.Rev. 442.

On the liability of promoters to the promoted corporation for stock issued for overvalued property, see, 1922, 35 Harv.L.Rev. 765.

full knowledge of the scheme at the time of the transaction, no wrong was then done to anyone, and the rights of the corporation are not increased when innocent subscribers subsequently are induced to come in. The wrong, if any, is personal to the individuals for fraud in the sale of shares to them. But this is practically a denial of justice. The small shareholder is barred by expenses of litigation, from asserting his individual wrong. The Massachusetts court and a majority of other state courts have recognized a right of action in the corporation for the benefit of all in such cases. Ballantine, Corporations (Callaghan & Co., 1946) 835–838.

(D) Under the New York General Corporation Law § 61,[5] a stockholder, in order to bring suit on behalf of a corporation, must show that "at the time of the transaction of which he complains" he was a stockholder or that his stock thereafter devolved upon him by operation of law. Does this section, in effect, abrogate the application of the Massachusetts rule in New York?

McCANDLESS v. FURLAUD.

Supreme Court of the United States, 1935. 296 U.S. 140, 56 S.Ct. 41, 80 L.Ed. 121.

Certiorari to the United States Circuit Court of Appeals for the Second Circuit to review a decree reversing a decree of the District Court of the United States for the Southern District of New York in favor of complainant in a suit by the receiver of an insolvent corporation to compel its promoters and their confederates to restore illicit gains.

[Maxime Furlaud was president and principal stockholder of Furlaud & Co., Inc., an investment banking corporation now dissolved. Kingston Corporation was a subsidiary of Furlaud & Co., owned and controlled by the same interests. Byron Co. and Chaucer Co. were closely related corporations.

Furlaud, through an agent, procured options to purchase gas lands in Western Pennsylvania for $2,572,989. The lands were fraudulently appraised at $7,000,000, and were actually worth about $2,700,000.

The Duquesne Gas Corporation (hereinafter referred to as Duquesne) was organized by the promoters' syndicate to purchase and operate the gas fields, with an authorized capital of 1,000 shares of no-par common stock, the entire issue being taken by Furlaud at 50¢ a share.

The promoters then advertised for subscriptions to bonds and notes to be issued by the corporation, representing in the circular that the issue was to finance the acquisition of land appraised at $7,000,000, and to provide cash for its development. The public issue was to consist of $4,000,000 of 6% mortgage bonds, to be sold at 97½% and $1,000,000 of 6½% mortgage notes to be sold at 98%.

The directors of Duquesne authorized a capital stock increase of 1,250,000 shares, of which Furlaud subscribed for 139,000 at 50¢ per share; Furlaud & Co. thus holding 140,000 shares of the entire stock issue.

Duquesne agreed to take over the gas fields from Kingston Co., the option holder, for $3,015,000 cash; $1,300,000 par value bonds, and

[5] *Infra*, p. 1230.

535,000 shares of no-par stock. Furlaud & Co. was to take the entire issue of mortgage notes at 88% and $2,700,000 of the mortgage bonds at 90%. The entire issue of mortgage bonds was thus divided between Furlaud & Co. and its subsidiary.

The promoters then sold the notes and bonds to the public, at a large profit to themselves.

As a result of the entire transaction, Duquesne had land worth about $2,500,000 and a working capital of $365,000. It had received $3,379,000, but had paid out $3,015,000 at once to the promoters for the gas fields. Its liabilities were stock, notes, and bonds; the bonds and notes being liens for $5,000,000, more than $2,000,000 above the cost of all its assets and working capital.

In two years, the company was in receivership. The receiver instituted this suit to recover the promoters' profits. The District Judge held the promoters liable for profits derived from the sale of the bonds and notes.[6] The judgment was reversed on appeal to the Circuit Court of Appeals.[7] The case now comes to the Supreme Court on writ of certiorari.]

MR. JUSTICE CARDOZO delivered the opinion of the Court.

* * * Promoters of a corporation stand in a fiduciary relation to it to this extent at least, that they will be chargeable as trustees if they deal with it unconscionably or oppressively or in violation of a statute, unless the liability for such misconduct has been effectually released. Dickerman v. Northern Trust Co., 176 U.S. 181, 203, 204, 20 S.Ct. 311, 44 L.Ed. 423; Brewster v. Hatch, 122 N.Y. 349, 362, 25 N.E. 505, 19 Am.St.Rep. 498; Erlanger v. New Sombrero Phospate Co., 3 A.C. 1218; affirming 5 Ch.Div. 73; Gluckstein v. Barnes, [1900] A.C. 240; Yeiser v. United States Board & Paper Co., C.C.A., 107 F. 340, 344, 52 L.R.A. 724. To what extent the approval of all the shareholders will relieve them of that burden is a question not susceptible of answer without considering the nature of the wrong and the interests affected. To some extent their position is akin to that of directors, though the limits of their duty are less definite and certain. Even for erring directors, however, there may at times be absolution if all the shareholders are satisfied. Holmes, Booth & Haydens v. Willard, 125 N.Y. 75, 25 N.E. 1083, 11 L.R.A. 170. The interests affected by approval will shape the power to approve.

Old Dominion Copper Mining & Smelting Co. v. Lewisohn was a case where promoters made a sale to a corporation in return for shares of stock; the par value of the shares being greatly in excess of the cost to the sellers of the property conveyed. The existence of this profit was known to the shareholders, for the shares belonging to the promoters were all that had then been issued. There was no evidence that the effect of the transaction was to make the company insolvent or to work a fraud upon its creditors or to divert the assets to forbidden uses or to violate a statute. "At the time of the sale to the plaintiff * * * there was no wrong done to any one." Id., 210 U.S. 206, at page 212, 28 S.Ct. 634, 636, 52 L.Ed. 1025. The grantors and

[6] 1933, 33 Col.L.Rev. 1065.

[7] 75 F.2d 977, C.C.A.N.Y. 1935.

their syndicate "were on both sides of the bargain, and they might issue to themselves as much stock in their corporation as they liked in exchange for their conveyance of their land." Id., 210 U.S. 206, at page 212, 28 S.Ct. 634, 636, 52 L.Ed. 1025. Far from planning to defraud, they "believed in the enterprise" and "preferred to take stock at par rather than cash." Id., 210 U.S. 206, at page 215, 28 S.Ct. 634, 637, 52 L.Ed. 1025. They had paid for the mines with their own money, and there were no creditors to be affected by anything they did. In such circumstances the ruling was that incoming shareholders, subscribing for new shares, were in the plight of those ahead of them and could have no better case. Davis v. Las Ovas Co., 227 U.S. 80, 33 S.Ct. 197, 57 L.Ed., 426, declined to extend the ruling to a case where the approval was by less than all the shareholders and without disclosure of the facts to others.

Old Dominion Copper Mining & Smelting Co. v. Lewisohn does not rule the case at hand. The effect of the promoters' conduct here was to saddle the company with liens beyond the value of its assets, mortgaged and unmortgaged. Through the diversion of the proceeds of the subscriptions to the use of Furlaud and confederates, the company became crippled and, indeed, insolvent at the outset of its business life. True, the findings of the District Court do not state in so many words that the company in its beginnings was insolvent as well as crippled. They do state, however, that the appraisals were grossly and fraudulently and wantonly excessive. Cost in and of itself, though far from conclusive, is still evidence of value (Parmenter v. Fitzpatrick, 135 N.Y. 190, 199, 31 N.E. 1032), especially where there is no market value in the strict or proper sense (Sinclair Refining Co. v. Jenkins Petroleum Process Co., 289 U.S. 689, 697, 53 S.Ct. 736, 77 L.Ed. 1449, 88 A.L.R. 496). In this case a witness for the complainant places a valuation upon the property in substantial correspondence with the cost. There is no opposing evidence in behalf of the defendants, and so the District Judge points out. In that state of the record, the promoters had the burden of answering and repelling the inculpatory evidence by proof that they had been true to their fiduciary duties and that their conduct had been fair and just. Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599, 41 S.Ct. 209, 65 L.Ed. 425; In re Smith, 95 N.Y. 516, 522; Allen v. La Vaud, 213 N.Y. 322, 326, 107 N.E. 570. The public had been invited to invest in the securities on the representation that the proceeds would be used for the purchase of the lands and for cash capital necessary or useful for the business. In fact, about three-fifths of the money was applied to the designated uses, the rest being kept for the use of the promoters. If this could be done without cutting down the value of the assets below the mortgage debt, the act would be so near to magic as to call for explanation from promoters not professing to be magicians. No word of explanation was offered at the trial or is now suggested in the briefs. In those conditions, only one legitimate inference was open to the trier of the facts, and this he must be taken to have drawn. The appraisals having been shown to be fraudulent, the one legitimate inference to be drawn from the defendants' silence was that the value of the lands was not greater than the cost, at least in any large amount. If that be so, the company

was made insolvent at the outset when the proceeds of the subscriptions were devoted to the use of the promoters.

No consent of shareholders could make such conduct lawful when challenged by the receiver as the representative of creditors. If the shareholders and the directors had combined with the promoters to despoil the corporation and defeat the remedies of creditors by a gift of half the assets, the gift could have been annulled either by the creditors directly or in their behalf by a receiver. Casey v. Cavaroc, 96 U.S. 467, 489, 490, 24 L.Ed. 779; Atlantic Trust Co. v. Chapman, 208 U.S. 360, 371, 28 S.Ct. 406, 52 L.Ed. 528, 13 Ann.Cas. 1155; Hamor v. Taylor-Rice Engineering Co., C.C., 84 F. 392, 399; American Can Co. v. Erie Preserving Co., C.C., 171 F. 540, 542; Sweet v. Lang, D.C., 14 F.2d 758, 760; Gillet v. Moody, 3 N.Y. 479; Pittsburg Carbon Co. v. McMillin, 119 N.Y. 46, 53, 23 N.E. 530, 7 L.R.A. 46. The distinction between such a situation and the present is one solely of degree. This is not a case where at the time of issuing the securities the shareholders and the promoters were the only ones concerned. Here at the moment of the conveyance the interests of bondholders and noteholders were put in jeopardy by a division of the proceeds that would make their mortgage worthless. The promoters could not receive for themselves or deliver to subscribers the bonds and notes of the company secured by deed of trust until title had been acquired to the lands covered by the deed. On the other hand, they could not pay the purchase price and acquire title to the lands without the proceeds of subscriptions, the contributions of the public. All this was known to the shareholders and known to the directors, for the promoters were the shareholders and the directors men of straw. In its effect upon subscribers the transaction was the same as if the proceeds of the bonds and notes had been paid into the treasury of the company and then paid out to the directors for the use of their confederates. It was not within the power of the shareholders to legalize this waste to the detriment of others. It would not have been within their power to bring that result to pass, though shareholders and promoters had been different persons, acting at arm's length. Still more clearly it was not within their power when shareholders and promoters were in substance the same persons. Cf. California-Calaveras Mining Co. v. Walls, 170 Cal. 285, 299, 149 P. 595; Pittsburgh Mining Co. v. Spooner, 74 Wis. 307, 42 N.W. 259, 17 Am.St.Rep. 149. Consent in such conditions, so far as it gives approval to conduct in fraud of the rights of others, is a word and nothing more. It is not in concord with realities. There is no occasion to consider whether the corporation itself at the instance of new shareholders would be permitted to disaffirm the fraud and maintain a suit in equity for appropriate relief. We put that question by. Enough that the receiver has the requisite capacity. A court of equity has taken hold of the assets of this company, intangible assets as well as tangible, for administration as a trust in accordance with equitable principles. Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371, 380, 14 S.Ct. 127, 37 L.Ed. 1113. Included in those assets are moneys fraudulently diverted to the prejudice of creditors. Cf. McClure v. Law, 161 N.Y. 78, 55 N.E. 388, 76 Am.St.Rep. 262; Bosworth v. Allen, 168 N.Y. 157, 166, 61 N.E. 163, 55 L.R.A. 751, 85 Am.St.Rep.

667. There is power at the instance of the receiver to bring them back into the trust.

These considerations without more would separate Old Dominion Copper Mining & Smelting Co. v. Lewisohn from the case before us now. Other aspects of the present case accentuate the division. What was done by the promoters here was in the teeth of a prohibition of the Constitution of Pennsylvania, the state where the corporation was formed and where its business was to be done. The Constitution of Pennsylvania provides (article 16, § 7): "No corporation shall issue stocks or bonds except for money, labor done, or money or property actually received; and all fictitious increase of stock or indebtedness shall be void." See, also, Act April 17, 1876, P.L. 30, 32, § 4; Purdon's Penna. Stats., title 15, § 131, 15 P.S.Pa. § 131. The prohibition is not escaped through the receipt of some property or money if the amount or value is inadequate. Big Spring Electric Co. v. Kitzmiller, 268 Pa. 34, 38, 110 A. 783; Commonwealth v. Reading Traction Co., 204 Pa. 151, 53 A. 755; In re Wyoming Valley Ice Co., D.C., 153 F. 787, 793, affirmed sub nom. Wiegand v. Albert Lewis Lumber & Mfg. Co., C.C. A., 158 F. 608, 610. True, the securities are valid in the hands of innocent purchasers, whatever the consideration (Guarantee Title & Trust Co. v. Dilworth Coal Co., 235 Pa. 594, 84 A. 516), but the liability of the directors or other fiduciaries who have put them into circulation is not thereby released. There are decisions in Pennsylvania that the Constitution is not self-executing. Grange National Bank v. Collman, 306 Pa. 200, 159 A. 26. That holding is irrelevant as to corporations such as this one, for there exists as to them an "implementing" statute (Purdon's Penna. Stats., supra), without restriction as to the form of remedy. Precedents exist for a suit at the instance of incoming shareholders, though the corporation was solvent and there was no injury to creditors. Spangler Brewing Co. v. McHenry, 242 Pa. 522, at page 530, 89 A. 665. Precedents exist in cases of insolvency for a suit by a trustee as the representative of creditors, and this though they became such after the securities were issued. Bingaman v. Commonwealth Trust Co., 15 F.2d 119, D.C.M.D.Pa., and cases there collected. Cf. Coleman v. Tepel, 230 F. 63, 70 C.C.A. 3, affirming, D. C., 229 F. 300; In re Wyoming Valley Ice Co., supra; Krebs v. Oberrender, 274 Pa. 154, 118 A. 19; Finletter v. Acetylene Light, Heat & Power Co., 215 Pa. 86, 64 A. 429. Nowhere is it held that delinquent fiduciaries who have nullified the statute may keep the profits for themselves when creditors will be injured unless the profits are returned. At times and for certain purposes the consent of shareholders may give validity to acts that would otherwise be voidable, if the only interests affected are those of the shareholders consenting. It can never be operative to the prejudice of others where consent is in derogation of the public policy of the state or the prohibition of a statute. Central Transportation Co. v. Pullman's Palace-Car Co., 139 U. S. 24, 59, 60, 11 S.Ct. 478, 35 L.Ed. 55; Kent v. Quicksilver Mining Co., 78 N.Y. 159, 185, 186, 187; Sheldon Hat Blocking Co. v. Eickemeyer Hat Blocking Mach. Co., 90 N.Y. 607, 613; Mann v. Edinburgh Northern Tramways Co. [H.L.] 68 L.T.,N.S., 96; Society of Practical Knowledge v. Abbott, 2 Beav. 560, 568. This case is plainly within the

scope of that exception. There was here a statutory prohibition, rooted in public policy. Gearhart v. Standard Steel Car Co., 223 Pa. 385, 389, 72 A. 699. The shareholders were not at liberty, at all events to the prejudice of creditors or other shareholders, present or prospective, to set that policy at naught. If the effect of what they did was to put illicit profits in the pockets of trustees, their consent will not avail to block pursuit and reclamation.

We have assumed in all this that the corporation was insolvent at the beginning of its business life. The assumption is well founded for reasons already stated, yet we do not need to go so far. Even though the company was not literally insolvent, the result would be the same. There would be a wrong to bondholders and noteholders if assets were depleted to the very brink of insolvency after fraudulent misrepresentations to the effect that there was an ample margin of security. What was taken out of the company in such circumstances would be taken subject to a trust and would so continue until the security thus depleted had paid the debt in full. The defendants do not assert that it is adequate for that today. Confusion of thought is inevitable unless the position of the wrongdoers as trustees is steadily kept in mind. What is here is something more than a tort of fraudulent representations to be redressed by the recovery of damages at the suit of the defrauded creditors. What is here is a tort growing out of the fraudulent depletion of the assets by men chargeable as trustees if they have failed to act with honor. There are important differences, moreover, between an overissue of stock, which may leave the assets unimpaired, and a withdrawal of cash, which puts the enterprise in peril. Cf. Arnold v. Searing, 78 N.J.Eq. 146, 162, 78 A. 762; Id., 73 N.J.Eq. 262, 265, 266, 67 A. 831; Eureka Mining, Smelting & Power Co. v. Lively, 59 Wash. 550, 110 P. 425. The duty of reclaiming assets so diverted and holding the wrongdoers to their duty as trustees is one that rests on the receiver. It is not within the power of wrongdoers and shareholders by any compact between themselves to make the duty less.

In considering the effect of Old Dominion Copper Mining & Smelting Co. v. Lewisohn, we have spoken until now of the bonds and notes only. It is necessary at this point to say something about the stock. Of the total issue, 535,000 shares went to Kingston as a bonus. The only pretense of value was a conveyance of the gas fields covered by the options, which were worth, as we have seen, no more than Kingston paid for them. In return for the conveyance of these lands, Kingston received $3,015,000 in cash, or more than the actual value of anything conveyed. It also received bonds of the par value of $1,300,000; and last of all the stock. Plainly the stock was a bonus and nothing else.

Furlaud and Kingston, having made themselves parties to a scheme whereby Duquesne was to be despoiled and its creditors were to be defrauded, became accountable, we think, for everything that came to them as a result of the conspiracy in excess of the consideration furnished on their side. They were not trustees as to the bonds and notes, and lawful owners of the shares, but trustees as to all; the transaction being a unit, infected with a common vice. Everything of profit

arising out of the abused relation must now be yielded up. Even after this is done, reparation will be incomplete. Restitution of the profits will not make up, without more, for the inadequacy of the overvalued land to return to the lienors their principal and interest. In such circumstances the shares, like the bonds and notes, must contribute what they can. The certificates, were they on hand, might be turned into the treasury of the company for sale, if they still had any value. The shares having been sold to others and the certificates being no longer subject to the mandate of the court, the trust that attached to them has been transferred to the proceeds, which, when paid to the receiver, will be used like other assets in reduction of the debts.

We are not unmindful of the contention that the sale by Kingston was at the rate of 50 cents a share (which for 85,000 shares would amount to $42,500), and that the sale for $850,000 was made by two other corporations, the Byron and the Chaucer. In view of the initial fraud, the burden was on Kingston and Furlaud to show that Byron and Chaucer were purchasers in due course, and not agents and confederates wearing the cloak of purchasers. King v. Doane, 139 U.S. 166, 173, 11 S.Ct. 465, 35 L.Ed. 84; Canajoharie National Bank v. Diefendorf, 123 N.Y. 191, 204, 205, 25 N.E. 402, 10 L.R.A. 676; Seymour v. McKinstry, 106 N.Y. 230, 240, 12 N.E. 348, 14 N.E. 94. We think that Byron and Chaucer were subject to an equal burden. Many suspicious circumstances point to guilty knowledge and justify a holding that the burden has not been borne. * * *

We find it immaterial that the defendants or some of them may be liable to creditors in common-law actions to recover damages for false representations as to the value of the assets. That is not the basis of the suit before us now. Moreover, the question is not here whether restitution of illicit profits as the outcome of this suit may be proved to mitigate the damages in actions by other plaintiffs, if any such there are. As we have striven to make clear, the receiver does not claim to have succeeded to the rights of bondholders or noteholders to recover damages for deceit. The wrong that is here redressed is the unlawful depletion of the assets whereby the company was made insolvent and the creditors were defrauded of their lawful rights and remedies.

The decree of the Circuit Court of Appeals reversing the decree of the District Court and dismissing the bill of complaint is reversed.

The decree of the District Court is modified by increasing the recovery against the defendants Maxime H. Furlaud and the Kingston Corporation in the sum of $850,000, with interest from June 6, 1930, when the shares of stock were sold, and by the award of judgment against the Byron Corporation in the sum of $425,000, with interest from June 6, 1930, and against the Chaucer Corporation for the same amount.

There will be a further modification by the allowance to the defendants Furlaud and the Kingston Corporation of so much of the sum of $300,000 as may be found on an accounting to have been disbursed for expenses that are chargeable in equity to the Duquesne Corporation, unless the amount of such allowance is fixed by agreement, approved by the court to which the receiver is accountable, in which

event the judgment against those defendants shall be reduced accordingly.

The decree of the District Court as thus modified is affirmed.

It is so ordered.

MR. JUSTICE ROBERTS, dissenting.

I think that the decree of the Circuit Court of Appeals should be affirmed. I concur in the view that the promoters of Duquesne Gas Corporation took an unconscionable profit which they reaped at the expense of a credulous and avid purchasing public. This fact, however much it may invite animadversion, ought not to induce the courts to disregard settled principles in an effort to deprive the respondents of the fruits of their scheme.

An examination of the pleadings and the facts found leads me to the conclusion that the receiver of the corporation is without standing to recover from the promoters.

The bill recites in somewhat different sequence the facts which are set out in the opinion of the court. It does not state that the properties were not worth the amount in bonds, stocks, and cash which the Duquesne Corporation paid for them. It fails to allege any fraudulent misrepresentation on the part of the respondents to purchasers of bonds or stock of the corporation. The allegation is made that Furlaud & Co., Inc., was, in the sale of the securities, a house of issue, meaning, of course, that it purchased the securities and resold them for its own account. Although the facts pleaded demonstrate that for some time after the organization of the Duquesne Corporation, and the issuance of its bonds and stock, Furlaud & Co., Inc., by itself and its subsidiaries, was the owner of every share of stock and every bond issued and outstanding, the bill asseverates, first, that the profit obtained on the sales of securities was a secret profit for which Furlaud and associates are accountable to the receiver, and, secondly, that they stood in a fiduciary relation to Duquesne and "caused all the proceeds of the sale of the bonds and notes in excess of $2,937,989, plus legitimate expenses, to be diverted from the Duquesne Corporation for whose use and benefit the proceeds of the sale of said bonds and notes were intended and defendants Furlaud and Reuter fraudulently misappropriated said moneys to their own use." The last assertion is the nearest approach to an allegation of agency or trust for or on behalf of the corporation. The prayer is for an accounting by the defendants of the moneys received by them, apparently on the theory that such moneys were received as agents for the corporation. On its face the pleading is self-contradictory. If what the defendants took constituted promoters' profits, the bill discloses that these were not secret profits taken to the disadvantage of innocent stockholders who had been brought into the corporation. Furlaud & Co. and the other defendants were on both sides of the transaction, and cannot be said to have deceived themselves as stockholders and bondholders and, upon familiar principles, those who took title to stock or bonds through them cannot assert rights higher than theirs. If, on the other hand, Furland & Co. was a house of issue, dealing on its own account, it cannot have been an agent of Duquesne for the sale of bonds and stock.

The District Court denied a motion to make the pleading more specific and certain, and the cause went to trial on the bill and answers. The proofs disclosed in detail the mechanics of the transaction whereby the promoters, at an expenditure of something in excess of $3,000,000, acquired $4,000,000 par value of first mortgage bonds, $1,000,000 of secured notes, and 675,000 shares of no-par common stock. Evidence was offered to prove that, at the date of the transfer, the property acquired was worth not to exceed $2,700,000. The defendants objected to this evidence on the ground that it was unsupported by any allegation in the bill. The court, nevertheless, received the proof and relied upon it for certain conclusions. There was also evidence that in the bond circulars issued by the defendants as a house of issue, and by a syndicate of bankers formed by the defendants to sell the securities to the public, these statements were made: That the properties had been appraised at something over $7,000,000 and that the bonds and notes were issued by the corporation "in connection with the acquisition of properties and to provide cash for developments, extensions and other corporate purposes." The proofs conclusively show, and it is not disputed, that Furlaud & Co., upon its individual credit and that of its subsidiary, the Kingston Corporation, obtained the funds with which to make settlement for the bonds, notes, and stock with the Duquesne Corporation and reimbursed themselves for these loans out of moneys paid by brokers in the purchase of the securities.

It is quite true that Furlaud & Co., Inc. had, prior to receipt of the bonds, notes, and stock, arranged for the sale of the bulk of the bonds to brokerage houses when, if, and as issued. This, however, is not an uncommon method of dealing, and in itself is insignificant so far as the fairness or unfairness of the transaction goes.

In its final analysis the situation comes, as the District Court indicated, to this: That Furlaud & Co., Inc. advanced the purchase money for the gas properties, contributed $364,500 to Duquesne as working capital and in return received the securities. The court added that, if without the circuity here resorted to, Furlaud & Co., Inc. had thus bought the securities direct at an inordinately low price, they could have done with them as they pleased. It held that they could not do with them as they pleased because of the method of settlement with the corporation to which they resorted. There is no specific finding by the District Court of fraud or misrepresentation on the part of Furlaud & Co., Inc., in the sale of the bonds. What is said is that the circulars misrepresented the facts. There is no finding that any present bondholder relied on any misrepresentation. Although it is insisted that Duquesne was insolvent from the moment of the settlement with Furlaud & Co., Inc. there is no finding to that effect. The District Court held that the promoters stood in a fiduciary relation to the corporation. It made no finding that the purchasers of bonds and notes were induced to purchase by misrepresentation; made no finding of loss or damage to such purchasers; made no finding that the purchasers understood Furlaud & Co., Inc. were acting as agents for Duquesne in the sale of its securities, but reached the conclusion, without any evidence to support it, that those who purchased bonds and notes from the promoters understood that the money which they paid in the

purchase of the securties was to go in solido into the treasury of Duquesne. A moment's reflection will show that this could not have been the case. The very circulars which were issued and on which the bonds were sold showed that they were not being sold for par and that commissions were being paid for their sale. It is quite evident from the circulars that these commissions were not being paid by Duquesne but by the brokers who were selling the bonds as principals.

Upon principle, and upon authority, the corporation had no cause of action in the circumstances against the promoters and the receiver's rights could rise no higher. * * *

The decree of the Circuit Court of Appeals should be affirmed.

MR. JUSTICE MCREYNOLDS, MR. JUSTICE SUTHERLAND, and MR. JUSTICE BUTLER concur in this opinion.[8]

NOTE

Does Erie Railroad Co. v. Tompkins, 304 U.S. 64, 58 S.Ct. 817, 1938. Affect the federal rule?

JEFFS et al. v. UTAH POWER & LIGHT COMPANY et al.

Supreme Judicial Court of Maine, 1940. 136 Me. 454, 12 A.2d 592.

THAXTER, JUSTICE. This is a bill in equity brought by five preferred stockholders of the Utah Power & Light Company, a Maine corporation, for an accounting by the Electric Power & Light Corporation, another Maine corporation, of certain alleged secret promoters' profits claimed to be held by the Electric Power & Light Corporation which it had received in part from its predecessor in title, the Utah Securities Corporation, a Virginia corporation, one of the original promoters in the organization of the Utah Power & Light Company, and in part in direct payments. Other relief such as cancellation of the common stock of Utah Power & Light Company, claimed to have been issued without consideration, or the payment for it is asked for. The plaintiffs bring the bill on behalf of themselves and of any stockholders who may wish to join and on behalf of the defendant, the Utah Power & Light Company.

The defendants demurred both generally and specially. These demurrers were sustained and a decree was entered dismissing the bill as to both defendants with costs. From such decree the plaintiffs have appealed. * * *

But there is another more fundamental reason why the plaintiffs cannot prevail. They are preferred stockholders and do not hold both preferred and common stock as was the case in Mason v. Carrothers, supra. Under the facts set forth in the bill it is impossible to see how they have been damaged by the acts complained of. At the time when preferred stock was offered to the public there was outstanding

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[8] Rehearing denied, 296 U.S. 664, 56 S.Ct. 304, 80 L.Ed. 473, 1935.

Notes, 1936, 49 Harv.L.Rev. 785; 1936, 34 Mich.L.Rev. 1189; 1936, 13 N.Y.U.L.Q. Rev. 577; 1935, 14 Tex.L.Rev. 79; 1936, U. of Chi.L.Rev. 484; 1936, 84 U. of Pa. L.Rev. 409; 1936, 2 U. of Pitt.L.Rev. 209; 1936, 45 Yale L.J. 511; 1936, 24 Calif.L. Rev. 465, 1936, 36 Col.L.Rev. 488, 1936, 20 Minn.L.Rev. 552, 1936, 10 St.John's L.Rev. 380, 1936, 10 U. of Cin.L.Rev. 193, 1936, 22 Va.L.Rev. 467.

$5,726,312.51 indebtedness of the corporation, and it had issued preferred stock of a par value of $3,000,000. Against this it had property which the bill concedes cost the promoters $14,146,740.51. There was therefore an equity represented by junior securities of $5,420,428.11. What did it matter to the plaintiffs whether that equity was represented by one share, or by 310,000, or by more than that? There might possibly have been an effect on voting control but the bill does not allege concealment from the plaintiffs of the amount of stock outstanding, but only of the want of consideration received for it. As a matter of fact if junior stock was issued, if for any consideration at all, the plaintiffs were benefited rather than harmed; for the protection back of their own investment was increased by the value of such property irrespective of the amount of securities issued against it.

There is nothing in this bill to show that the shares of stock issued to these promoters in any way impaired the security of the plaintiffs' stock or any preference to which it was entitled. The preferred stockholders so far as the bill indicates had no interest in the share of the corporate assets of those holding securities junior to theirs, nor in the earnings which might accrue over and above the amount necessary to satisfy the dividends on the preferred stock. The preferred stockholder was given no bonus of common stock as in the case of Mason v. Carrothers, supra. A plaintiff, who can show no injury to himself by reason of the facts of which he complains, surely has no standing in court. For a discussion of the rights of preferred stockholders in this situation see an article by A. A. Berle, Jr., 42 Harv.L.Rev. 748, 759–762. * * *

The plaintiffs do suggest in their brief that they have suffered an injury in that the cushion of protection behind their investment was not what it was represented to be. They do not claim any direct misrepresentation. But they suggest that they had a right to assume that the 300,000 shares of common stock and the 78,370 of second preferred represented $37,837,000 of assets. Assuming it all to be true they nowhere allege that their stock is worth any less than they paid for it. But beyond this counsel cite no case holding that a preferred stockholder has any absolute right to compel common stockholders to pay in full for the common stock issued to them, nor is any such case not based on a statute likely to be found. * * *

Appeal dismissed.

Decree dismissing the bill with costs affirmed.

BALL v. BREED, ELLIOTT & HARRISON.

Circuit Court of Appeals of the United States, Second Circuit, 1923. 294 F. 227.

Appeal from the District Court of the United States for the Southern District of New York.

Suit in equity by Wilbur L. Ball, receiver of the Haytian American Corporation, against Breed, Elliott & Harrison. From a decree dismissing the complaint, and an order denying its motion to amend the complaint, plaintiff appeals. Decree affirmed, and appeal from an order denying the motion for leave to amend dismissed.

[Defendant, another bank, and one Tippenhauer made certain secret agreements in the process of promoting the Haytian-American Corporation. The banks were to make a profit of $1,100,000 and Tippenhauer was to receive all the common stock, 60,000 shares to be issued. The bankers were also to have the exclusive right to buy 55,000 shares of preferred stock at par. After the agreements were executed, a syndicate was formed at the bankers' instigation. The bankers were to be its managers, and were to sell the preferred and some common stock when, as and if issued to the syndicate for $5,225,000. The company was organized; the bankers as individuals subscribed for the 55,000 preferred shares and appropriate entries were made on the corporate books. This suit was brought on the theory that the promoters' profits were made without the knowledge or consent of the corporation.]

MAYER, CIRCUIT JUDGE. * * * The ultimate fact upon which decision must rest is that the alleged secret profit was a matter of contract between Tippenhauer and the bankers, and as these owned all the preferred and all of the common and all of the founders' stock which was either subscribed for or intended to be issued, there were no persons having any rights to receive stock from the corporation. Thus there were no innocent stockholders. In other words, there was no fraud upon the corporation. * * * It is nowhere alleged as a fact, nor can it be inferred, that there were any innocent stockholders at the time of the transaction complained of. If, then, there was a fraud, it was not against the corporation, and a cause of action, if any, is personal to the purchasers of the stock. The fraud, if any, is what has been called a subsidiary fraud not affecting the corporation. Allowing to the complaint the most favorable inference, all that can be said is, as concisely stated by the District Court, that:

"These transactions between the defendants and the subscribers to their syndicate had nothing to do with the formation of the corporation, the syndicate subscribers only agreed with the syndicate managers to take what the managers get for them, and they got it through the managers."

Appellant puts forward the theory that, because of the dealings with the syndicate and the dealings of the members of the syndicate with the public prior to incorporation, therefore both the public and the syndicate members were equitable stockholders at the time of the transactions complained of. This theory is characterized by ingenuity rather than by substance, and in our view does not invite discussion.

In view of the conclusions stated, supra, we deem it unnecessary to discuss some other points which have been raised by the parties.

Decree affirmed, with costs, and appeal from order denying motion for leave to amend dismissed.[9]

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[9] *Cert. denied*, 264 U.S. 584, 44 S.Ct. 333, 68 L.Ed. 861, 1924. See Notes on this decision in 1924, 24 Col.L.Rev. 542, 1924, 8 Minn.L.Rev. 540.

Accord: Hays v. The Georgian, Inc., et al., 280 Mass. 10, 181 N.E. 765, 85 A.L.R. 1251, 1932; Notes, 1933, 85 A.L.R. 1262, 1269, 1278, 1282, 1934, 47 Harv.L.Rev. 1031, 1932, 19 Va.L.Rev. 274. See, also, Note, 1924, 8 Minn.L.Rev. 520.

NOTE

Only a few cases involving promoters' liability for secret profits have been litigated in recent years. The Securities Act of 1933, 15 U.S.C.A. § 77a and Form S-1, Item 5, Form S-2, Item 9 require full disclosure in the registration statement and prospectus of promoters' names, addresses, amounts received for services, etc. See, McGowan, Legal Controls of Corporate Promoters' Profits, 1937, 25 Geo.L.J. 269; Note, 1940, 28 Geo.L.J. 535.

B. MANAGEMENT IN OPERATION

1. FORMAL REQUISITES OF CORPORATE ACTION

NEW YORK GENERAL CORPORATION LAW

§ 27. *Directors; qualifications; powers of majority.* The business of a corporation shall be managed by its board of directors, all of whom shall be of full age and at least one of whom shall be a citizen of the United States and a resident of this state. Unless otherwise provided a majority of the board at a meeting duly assembled shall be necessary to constitute a quorum for the transaction of business and the act of a majority of the directors present at such a meeting shall be the act of the board. The by-laws may fix the number of directors necessary to constitute a quorum at a number less than a majority of the board, but not less than one-third of its number.

Subject to the by-laws, if any, adopted by the members of the corporation, the board may make necessary by-laws. If any by-law regulating an impending election of directors is adopted or amended or repealed by the board, there shall be set forth in the notice of the next meeting of the members of the corporation for the election of directors the by-law so adopted or amended or repealed, together with a concise statement of the changes made.

§ 28. *Acts of directors.* Whenever, under the provisions of any corporate law a corporation is authorized to take any action by its directors, action may be taken by the directors, regularly convened as a board, and acting by a majority of a quorum, except when otherwise expressly required by law or the by-laws and any such action shall be executed in behalf of the corporation by such officers as shall be designated by the board. Any business may be transacted by the board at a meeting at which every member of the board is present, though held without notice.

NEW YORK STOCK CORPORATION LAW

§ 55. *Directors, election of.* The directors of every stock corporation shall be chosen at the time and place fixed by the by-laws of the corporation by a plurality of the votes at such election, provided that, except as to a special election as provided for in the general corporation law, the certificate of incorporation or other certificate filed pursuant to law, or the by-laws, may fix the number of shares, not exceeding a majority, necessary to constitute a quorum. When cumulative voting

is authorized by the certificate of incorporation or by any certificate filed pursuant to law, any provision regarding a quorum must be contained in such certificate. Each director shall be a stockholder unless otherwise provided in the certificate of incorporation, or in a by-law adopted by a stockholders' meeting. At least one-fourth in number of the directors of every stock corporation shall be elected annually. Notice of the time and place of holding any election of directors shall be given as prescribed in section forty-five. Vacancies in the board of directors shall be filled in the manner prescribed in the by-laws.

If the number of directors provided for in the certificate of incorporation or other certificate filed pursuant to law be indefinite, the number of directors to be chosen within the maximum and minimum limits shall be determined in the manner prescribed by the by-laws.

If, pursuant to section thirty-five or the by-laws, the number of directors be increased, the additional directors may be elected by a majority of the directors in office at the time of the increase, or, if not so elected prior to the next annual meeting of the stockholders, or if the by-laws so provide, they shall be elected by vote of the stockholders. If the certificate of incorporation or other certificate filed pursuant to law provides that the directors be divided into two or more classes, whose terms of office shall respectively expire at different times, the additional directors shall be divided among such classes as nearly as practicable in proportion to the respective numbers of such directors constituting each class prior to such increase.

DELAWARE GENERAL CORPORATION LAW

Sec. 9. *Board of Directors; Qualifications; Powers; Classes; Committees of Directors:*—The business of every corporation organized under the provisions of this Chapter shall be managed by a Board of Directors, except as hereinafter or in its Certificate of Incorporation otherwise provided. The number of directors which shall constitute the whole board shall be such as from time to time shall be fixed by, or in the manner provided in, the by-laws, but in no case shall the number be less than three. Directors need not be stockholders unless so required by the Certificate of Incorporation or the by-laws. The Directors shall hold office until their successors are respectively elected and qualified, and a majority of them shall constitute a quorum for the transaction of business, unless the by-laws shall provide that a different number shall constitute a quorum, which in no case shall be less than one-third of the total number of directors nor less than two directors. The Board of Directors may, by resolution or resolutions, passed by a majority of the whole board, designate one or more committees, each committee to consist of two or more of the directors of the corporation, which to the extent provided in said resolution or resolutions or in the by-laws of the corporation, shall have and may exercise the powers of the Board of Directors in the management of the business and affairs of the corporation, and may have power to authorize the seal of the corporation to be affixed to all papers which may require it. Such committee or committees shall have such name or names as may be stated in the by-laws of the cor-

poration or as may be determined from time to time by resolution adopted by the Board of Directors. The directors of any corporation organized as aforesaid may, by the Certificate of Incorporation or any amendment thereto, or by a vote of the stockholders, be divided into one, two or three classes: the term of office of those of the first class to expire at the annual meeting next ensuing; of the second class one year thereafter; of the third class two years thereafter, and at each annual election held after such classification and election, directors shall be chosen for a full term, as the case may be, to succeed those whose terms expire. But the provisions of this Section shall not apply to corporations not for profit, for which it is desired to have no capital stock; and the business of every such corporation organized under the provisions of this Chapter shall be managed as provided in its Certificate of Incorporation. A Director of any corporation organized under the provisions of this Chapter, or a member of any Committee designated by the Board of Directors pursuant to authority conferred by this Chapter, shall in the performance of his duties be fully protected in relying in good faith upon the books of account or reports made to the corporation by any of its officials, or by an independent certified public accountant, or by an appraiser selected with reasonable care by the Board of Directors or by any such Committee, or in relying in good faith upon other records of the corporation.

Sec. 81. *Waiver of Notices:*—Whenever any notice whatever is required to be given under the provisions of this Chapter, or under the provisions of the certificate of incorporation or by-laws of any corporation organized under the provisions of this Chapter, a waiver thereof in writing, signed by the person or persons entitled to said notice, whether before or after the time stated therein, shall be deemed equivalent thereto. Whenever the vote of stockholders at a meeting thereof is required or permitted to be taken in connection with any corporate action, by any Section of this Chapter, the meeting and vote of stockholders may be dispensed with, if all of the stockholders who would have been entitled to vote upon the action if such meeting were held, shall consent in writing to such corporate action being taken, provided, however, that nothing herein contained shall be construed to alter or modify the provisions of Section 65 of this Chapter. In the event that the action which is consented to is such as would have required the filing of a certificate under any of the other sections of this Chapter, if such action had been voted upon by the stockholders at a meeting thereof, the certificate filed under such other section shall state that written consent has been given hereunder, in lieu of stating that the stockholders have voted upon the corporate action in question, if such last mentioned statement is required thereby.

(a) Directors Meetings

NOTE

The procedure by which Directors act is well settled by statute, charter provisions, By-Laws and decided cases. Every Director must have prescribed notice

(the courts excusing failure to give notice under exceptional circumstances where the notice would obviously be futile). The Directors must meet at least annually and have full opportunity for discussion and exchange of ideas; a quorum must be present. Where Directors meet without notice, the meeting is valid if all are present. The Directors may waive notice. Where charter or statutes permit, functions of the Board of Directors may be carried on by an Executive Committee.

But the human tendency to cut corners or to be slipshod is unvarying; and businessmen frequently have crowded days, conflicting engagements and an aversion to meeting and talking where their action is formal or the conclusion foregone. In consequence, the lawyer in practice not infrequently finds that the Board of Directors, commonly without bad intention, violates its rules of procedure in a number of ways. Of those, the most frequent are:

(a) Desire of a Director to assign someone else in his place to "represent him" at a meeting. This is plainly invalid: the Director as an individual was elected to the Board; he cannot pass on this function to any one else;

(b) The desire of Directors not to bother with meeting, but having made up their minds on action and exchanged ideas informally, either with each other or through a senior officer of the corporation, to have the Secretary write up a set of Minutes as though the meeting had been held; along with a waiver of notice of the meeting which the Directors sign. This makes a clear but, unhappily, a false record: waiver of notice by all Directors, the Minutes of a meeting which in fact never took place, authorizing action which nevertheless has general assent;

(c) The tendency to have a meeting on the spur of the moment because a number of Directors are handy and it is known that the absent Directors would agree to the proposed action. A waiver of notice of the meeting is then drawn, and signed by those present, and is sent to and signed by the absentees, who are recorded as absent. The record is then complete in all respects and accurate as far as it goes. All Directors did waive notice; the Directors stated to be present at the meeting were present; the action taken was taken; and the unstated fact is that the absentee Directors were not notified of the meeting in advance, though their subsequent signature on the waiver of notice is ample evidence that they consented to the proceedings after the fact;

Query: Whether the waiver of notice of such meeting cures the defect of the meeting?

(d) A modern tendency in certain large corporations, where Directors reside in different cities and centers, to hold meeings by telephone, establishing a joint circuit on which each can hear all the others. The meeting is then regularly conducted as though all were present in the same room. The records, complete with notice, waiver of notice, and minutes, are then written up and an accurate account of what did happen—except for the fact that the Directors were not physically in the same place.

Query: Can this be interpreted as a meeting?

In most corporations a large proportion of the business transacted is formal or is non-controversial. Where this is the fact, there is no reasonable probability that the action taken at meetings of this kind will be attacked; and indeed where the principal desire is to secure a consensus of assent on policy, formal action may not be necessary. Yet, when the action taken calls for technical formal perfection (for instance, authorizing a mortgage on property or the like) or when there is a real division of opinion (or there might be a real division of opinion if all the facts were amply developed through discussion), the danger of attack is far greater. Naturally, if the reason for disregarding the formalities is designed to prevent some Directors from knowing about, or expressing their opinion on, a course of action, violation of the established procedural rules becomes directly fraudulent.

The purpose of procedural rules is to assure: first, that every person entitled to participate in a decision shall have opportunity to do so; second, that action shall

be considered action; third, to assure that the judgment of all Directors shall be brought to the attention and consideration of all other Directors so that a joint result may be reached. In purely formal non-controversial action, probably a certain amount of corner-cutting is inevitable and Directors are always impatient with mere ceremonial action. When, however, there is the slightest difference of opinion on any problem of real importance, observation of the ceremony makes all the difference between true corporate action and a half-done, badly done, or perhaps unethical or even objectionable procedure. It does not follow that every violation of ceremonial procedure establishes a grievance requiring remedy; but failure to observe the ceremony unquestionably leaves all of the parties concerned in it in a weak legal position should anything done or omitted become the subject of attack.

THE ——— COMPANY

SPECIAL MEETING OF DIRECTORS

Minutes of a Special Meeting of the Board of Directors of The ——— Company, a New Jersey corporation, held at No. 15 Exchange Place, Jersey City, N.J. on April 16, 19——, at 3:00 o'clock, P. M., pursuant to written Waiver of Notice of the meeting.

Present

——————— ———————

——————— ———————

———————

being all of the Directors of the Corporation.

Mr. ——— acted as Chairman of the meeting and Mr. ——— acted as Secretary of the meeting.

The Secretary of the meeting presented the following written Waiver of Notice of the meeting, duly signed by all of the Directors of the Company.

THE ——— COMPANY

WAIVER OF NOTICE OF SPECIAL MEETING OF BOARD OF DIRECTORS

The undersigned, constituting all of the Directors of The ——— Company, a New Jersey corporation, hereby waive all notice of the time, place and purposes of a Special Meeting of the Board of Directors of said Company, and of the business to be transacted thereat, and designate the 16th day of April, 19——, at 3:00 o'clock in the afternoon as the time and the offices of ———as the place of said meeting; the purposes of said meeting being to elect officers, to authorize the submission to the stockholders of a proposal to authorize the Board of Directors, in its discretion, to accelerate the amortization of the total payments to the insurers on account of past service benefits under the Employees' Retirement Plan and to transact all such other business as

may be deemed necessary, proper or advisable in connection with the foregoing matters or otherwise.

Dated: ———, 19——.

———————

———————

———————

———————

———————

The Secretary of the meeting advised that at the Annual Meeting of Stockholders held earlier on the same day, all of the Directors of the Company previously in office had been reelected and, accordingly, it was in order for the meeting to proceed to the election of officers.

On motion duly made and seconded, the following persons were appointed to the offices set before their respective names, to hold office until the next annual election of officers by the Board of Directors and until another is chosen and qualified in his stead, by the unanimous vote of all the Directors:

President ———
Vice President ———
Secretary ———
Treasurer ———

The Chairman then presented to the meeting a report by the management with respect to the Employees' Retirement Plan of the Company and particularly with reference to the payments made by the Company to the insurers for the purchase of deferred annuities with respect to prior services. He stated that the said Plan had previously been approved by the stockholders and that in the Proxy Statement submitted at the time their approval was requested it was stated that the Company intended to make specified annual payments for this purpose over a period of approximately twenty years, that to date such payments had been made in approximately such amount and if they are continued at that rate it is estimated that the past service provisions of the Plan will have been fully amortized within twenty years. The management now believes that at times it might be advantageous to the company to increase the amount of one or more such payments and thereby accelerate the amortization, without in any way adversely affecting the aggregate amount to be paid.

General discussion followed, after which, on motion duly made and seconded, the following resolutions were unanimously adopted by the vote of all Directors present:

Resolved, that this Board of Directors hereby formulates and declares advisable action by the stockholders concerning the Employees' Retirement Plan heretofore approved by the stockholders whereby the Board of Directors will be authorized in its discretion from time to time to accelerate the amortization of the total payments to the insurers on account of past service benefits under the Employees' Retirement Plan without in any way increasing the aggregate total amount of the payments heretofore authorized to be made for such purposes, and further

Resolved, that a meeting of the stockholders be, and the same hereby is, called to take action upon such proposal with respect to the Employees' Retirement Plan, which meeting shall also be the annual meeting of the stockholders to be held on ———.

There being no further business to come before the meeting, on motion duly made and seconded the meeting then adjourned.

____
Chairman

____
Secretary of the meeting

BALDWIN AND THE STATE NATIONAL BANK OF MINNEAPOLIS v. CANFIELD

Supreme Court of Minnesota, 1879. 26 Minn. 43, 1 N.W. 261.

Appeal from an order of the district court, County of Hennepin, denying defendant's motion for new trial.

Berry, J. * * *

Fourth.—Said deed was not the act and deed of said association, and did not convey to Canfield the legal title of the real estate purporting to be conveyed thereby. * * *

The fourth conclusion is called in question by the counsel for defendant Canfield, but we have no doubt of its correctness. As we have already seen, the court below finds that by its articles of incorporation the government of the Minneapolis Agricultural and Mechanical Association, and the management of its affairs was vested in the board of directors.

The legal effect of this was to invest the directors with such government and management *as a board*, and not otherwise. This is in accordance with the general rule that the governing body of a corporation, as such, are agents of the corporation only as a board and not individually. Hence, it follows that they have no authority to act, save when assembled at a board meeting. The separate action, individually, of the persons comprising such governing body, is not the action of the constituted body of men clothed with the corporate powers. [Citing cases.] * * *

In Vermont, a somewhat different rule is allowed, as in the Bank of Middleburg v. R. & W. R. Co. 30 Vt. 159. In that case, and perhaps others in that state, it is held that directors may bind their corporation by acting separately, if this is their usual practice in transacting the corporate business. But we think the general rule before mentioned is the more rational one, and it is supported by the great weight of authority. From the application of this rule to the facts of this case, it follows that the fourth conclusion of law, viz., that the deed purporting to be made by the association was not the act and deed of such association, and therefore did not convey the title to the premises in question to Canfield, is correct. The directors took no action as a board with reference to the sale of the premises or the execution of any deed thereof. So far as in any way binding the corporation is concerned, their action in executing the deed was a nullity.

They could not bind it by their separate and individual action. Hence, it follows that the so-called deed is not only ineffectual as a conveyance of real property, but equally so as a contract to convey. * * *

Order affirmed.

BAYER et al. v. BERAN et al.[a]

Supreme Court of New York, 1944. 49 N.Y.S.2d 2.

SHIENTAG, JUSTICE. * * * It is urged that the expenditures were illegal because the radio advertising program was not taken up at any formal meeting of the board of directors, and no resolution approving it was adopted by the board or by the executive committee. The general rule is that directors acting separately and not collectively as a board cannot bind the corporation. There are two reasons for this: first, that collective procedure is necessary in order that action may be deliberately taken after an opportunity for discussion and an interchange of views; and second, that directors are the agents of the stockholders and are given by law no power to act except as a board. Gerald v. Empire Square Realty Co., 195 App.Div. 244, 187 N.Y.S. 306; Knapp v. Rochester Dog Protective Ass'n, 235 App.Div. 436, 257 N.Y. S. 356. Liability may not, however, be imposed on directors because they failed to approve the radio program by resolution at a board meeting.

It is desirable to follow the regular procedure, prescribed by law, which is something more than what has at times, thoughtlessly been termed red tape. Long experience has demonstrated the necessity for doing this in order to safeguard the interests of all concerned, particularly where, as here, the company has over 1,375,000 shares outstanding in the hands of the public, of which about 10% are held by the officers and directors.

But the failure to observe the formal requirements is by no means fatal. Young v. United States Mortgage & Trust Co., 214 N.Y. 279, 284, 285, 108 N.E. 418, 420; Catholic F. M. Society of America v. Oussani, 215 N.Y. 1, 7, 109 N.E. 80, 82, Ann.Cas.1917A, 479; Gorrill v. Greenless, 104 Kan. 693, 180 P. 798; 2 Fletcher, Cyc. Corp. § 394. The directorate of this company is composed largely of its executive officers. It is a close, working directorate. Its members are in daily association with one another and their full time is devoted to the business of the company with which they have been connected for many years. In this respect it differs from the boards of many corporations of comparable size, where the directorate is made up of men of varied interests who meet only at stated, and somewhat infrequent, intervals.

The same informal practice followed in this transaction had been the customary procedure of the directors in acting on corporate projects of equal and greater magnitude. All of the members of the executive committee were available for daily consultation and they discussed and approved the plan for radio advertising. While a greater

[a] The statement of facts and that part of the opinion dealing with the directors breach of duty appears *infra*, p. 997.

degree of formality should undoubtedly be exercised in the future, it is only just and proper to point out that these directors, with all their loose procedure, have done very well for the corporation. Under their administration the company has thrived and prospered. Its assets increased from $44,500,000 in 1935 to upwards of $103,000,000 in 1942. Its net profits, after taxes, doubled during that period, rising from $4,000,000 in 1935 to $8,000,000 in 1942; its net sales rose from $27,000,000 to upwards of $86,000,000; and its dividend disbursements to stockholders exceeded $29,500,000.

The expenditures for radio advertising, although made without resolution at a formal meeting of the board, were approved and authorized by the members individually, and may in no sense be considered to have been ultra vires. The resolution adopted by the board on July 6, 1943, with all of the directors present, except two who were resident in England, while expressly ratifying only the renewal of the broadcasting contract, may be deemed a ratification of all prior action taken in connection with the radio advertising. When this resolution was adopted, the Celanese Hour had been on the air to the knowledge of all the directors for eighteen months. Moreover, acceptance and retention of the benefits of the radio advertising, with full knowledge thereof, was as complete a ratification as would have resulted from any formal all-inclusive resolution. Young v. United States Mortgage & Trust Co., 214 N.Y. 279, 285, 108 N.E. 418, 420; Bussing v. Lowell Film Prod., Inc., 233 App.Div. 493, 494, 253 N.Y.S. 719, 720, 721, affirmed 259 N.Y. 593, 182 N.E. 194. * * *

CHASE et al. v. TUTTLE et al.

Supreme Court of Errors of Connecticut, 1888. 55 Conn. 455, 12 A. 874.

LOOMIS, J. This is an action of replevin, brought by the trustee of Brown & Bros., an insolvent corporation, for certain goods that were on the 4th of January, 1886, attached by the defendant, as a deputy-sheriff, on the suit of the National Shoe & Leather Bank of New York against the corporation. On the evening of the same day an assignment for the benefit of all the creditors of the corporation was made, pursuant to a vote of a majority of its directors, as is claimed, which was lodged on file in the probate court, and subsequently accepted, approved, and recorded by that court; and the plaintiffs were appointed and qualified as trustees. The sole defense against this action is that the assignment was invalid and of no effect. The claimed illegality of the assignment is based upon three objections only: (1) That two of the five directors, being out of the state at the time, did not receive any notice of the meeting; (2) that, of the three persons who acted as directors in the matter in question, one, namely Henry R. Coit, was not legally a director, though chosen as such, because he was not a stockholder of Brown & Bros.; (3) that the notices of the meeting sent to the directors did not specify the object of the meeting, as required by statute.

1. We do not think the assignment invalid for want of actual notice to the two directors who were at the time absent from the state.

Notice was sent by telegram to them, as to the others, at their address in this state; but one being in the territory of Montana, and the other in South Carolina, they failed to receive the notices. Under these circumstances, it would seem unreasonable to hold that a majority of the whole number, being present, could not do a legal act binding the corporation. The exigency demanded immediate action to save the property and to save expense. It is easy to see how disastrous might be the consequences were we to adopt the principle contended for by the defendants. The situation of the absent directors might be much more remote and inaccessible than in the present case, requiring many months, or even years, to reach them by actual notice. Must the corporation remain paralyzed all this time, without ability to protect itself? But the suggestion was made, in the argument in behalf of the defendants, that it might be treated as a case of vacancy, which the remaining directors could fill, pursuant to the act of 1880, (Sess. Laws 1880, p. 561, § 7.) If, however, the office was vacant as to the two absent directors, then surely the remaining directors could lawfully represent the corporation; for there is no general law or principle requiring vacancies in the board of directors to be filled before the remaining directors can act in the business of the corporation: provided, of course, the number left is sufficient to constitute a legal quorum. Under our General Statutes, p. 279, § 12, "a majority of the directors of any corporation, convened according to the by-laws, shall constitute a quorum for the transaction of business." In order, probably, to avoid a doubt that might arise whether a general assignment was such business as was contemplated under the above statute, the legislature, by the act of 1885, (Sess. Laws 1885, p. 493,) provided that the assignment of any corporation may be made by the directors in legal meeting called for such purpose. This, however, was not intended to change the rule as to a quorum under the preceding statute. There can be no doubt that a majority of the directors could make a valid assignment. * * *

3. The only remaining objection is that the meeting of the directors for the making of the assignment was illegal for defects in the notice. The only by-law or rule adopted, relative to the matter, prescribed simply that "meetings of directors may be held as often, at such place, and in such manner, as they may from time to time determine." No formality whatever is prescribed; and if all the directors happened to be together, and agreed to hold a meeting immediately for a particular object within their jurisdiction, we do not see how their action could be impeached on that ground. As the want of actual notice to the two directors who were absent from the state, at places so remote that they could not be reached, has been excused in this case, all the directors capable of acting under the circumstances were present. But it is said that the statute which empowers directors to make an assignment requires that "the meeting be called for such purpose;" and, in this connection, the defendants rely on the finding which says that there was no evidence that the telegram contained any notification as to the purpose of the proposed meeting. It will be observed that this is not a finding that the purpose was not specified, but only that the contents of the telegram had not been

proved by either party; but, under the circumstances we are about to mention, the burden of showing that the object was not specified was on the defendants. The record of this meeting is annexed as part of the finding, and it says: "At a special meeting of the directors of Brown & Bros., called for the purpose of making an assignment of its estate in insolvency for the benefit of all the creditors, pursuant to the statutes," etc. Upon this record, until the contrary is found, it must be presumed that the purpose was specified in the call. This principle is sustained by the case of Sargent v. Webster, 13 Metc. 504, where the validity of an assignment by a corporation for the benefit of creditors was sought to be impeached for want of notice to all the directors. Chief Justice Shaw disposed of the objections as follows: "Another objection of the same kind is that it does not appear that notice of the meeting was given to all the directors. But the contrary does not appear; and it would be hazardous to decide that every vote passed by an aggregate body is void, if it do not appear by the record that all were notified. We believe it not usual in corporate records to state how the members were notified. The presumption, omnia rite acta, covers multitudes of defects in such cases, and throws the burden on those who would deny the regularity of a meeting, for want of due notice, to establish it by proof." Our own court, in Lane v. Brainerd, 30 Conn. 565, applied the same principle both to directors' and to stockholders' meetings. The mere record of the meeting in the former case was presumptive proof that all the directors had been duly notified; and in the latter case the mere record of the organization of a corporation was presumptive evidence of a fact which was an indispensable condition precedent to its lawful organization.

We advise judgment for the plaintiffs.

BELLE ISLE CORPORATION v. MacBEAN et al.[3]

Court of Chancery of Delaware, 1946. 49 A.2d 5.

SEITZ, VICE-CHANCELLOR. * * * the complainant corporation contends that no quorum was present at the June 3, 1944 directors' meeting when the issuance of the stock in question was allegedly authorized as partial compensation for MacBean's past services to the corporation. The defendant MacBean on the contrary contends that a quorum was present under conditions hereinafter discussed.

The following by-laws of the corporation were admittedly part of the written corporate by-laws at the date of the meeting held June 3, 1944:

"[Article II] Section 5. Number and Quorum:—The number of directors shall be Ten. A majority of the directors shall constitute a quorum for the transaction of business. Directors need not be stockholders.

* * * * * * * * * * *

"[Article V] Section 3. Increase of Number of Directors:—The number of directors of the corporation shall be fixed by the By-laws

[3] Statement of facts and latter part of opinion, supra, p. 231.

and shall not be altered except at a stockholders meeting by a vote of the stockholders owning 75% of the shares entitled to vote thereon. In case of any increase in the number of directors the additional directors may be elected by the directors, or by the stockholders at an annual or special meeting by a plurality vote."

Article II, Section 5 had been amended by a resolution of the stockholders adopted June 7, 1939, whereby the number of directors was increased from seven to ten. All parties concede that this increase was made in 1939 in order to provide for representation to the so-called Ware-Wasson group when it performed a certain agreement involving the corporation's stock. The so-called Ware-Wasson agreement expired June 30, 1940 without ever being carried out so that this group never was represented on the board of directors.

No meeting of the stockholders or of the board of directors of complainant corporation was held between June 30, 1940 (when the Ware-Wasson agreement expired) and June 3, 1944, the date on which the directors allegedly authorized the issuance of the 75,000 shares here involved. The importance of this time interval will appear.

It is conceded by the defendants at the meeting of June 3, 1944 there were present only the following four directors: MacBean, Huppuch, Irish and Corcoran. And it is undisputed that at no time during the period with which we are here concerned was any formal amendment to the by-laws ever adopted changing the number of directors from the ten provided for by Article II, Section 5.

It necessarily follows that if the by-law provision calling for ten directors was operative at the meeting of June 3, 1944, then a quorum of directors under Delaware law as applied to the charter and by-laws of the corporation would be six directors. This is so because it was held in Bruch v. National Guarantee Credit Corporation, 13 Del. Ch. 180, 184, 116 A. 738, 740, that "The rule is that the number necessary to constitute a *quorum,* under a by-law such as appears in this case, is a majority of the entire board notwithstanding there may be vacancies in the board at the time." The pertinent by-law provision of the corporation involved in the Bruch case was in substance identical with the complainant corporation's by-law governing quorum requirements, and, as a consequence, the quoted principle is operative.

As stated, only four directors were present at the June 3, 1944 meeting and one of these was the defendant MacBean. Passing complainant's contention that defendant MacBean, being interested in the transaction, could not be counted for quorum purposes, it is clear that even including MacBean for quorum purposes there was no quorum present at the June 3 meeting unless, as defendant contends, "by Established Practice to the Contrary Acquiesced in by the Stockholders", the quoted by-law (Article II, Section 5) was amended so as to provide for only seven directors.

The defendant MacBean's case turns then, at this time, exclusively on whether or not the corporation's by-law had been amended by custom so that at the June 3, 1944 meeting it had a board of seven directors rather than ten. Of course, if defendant MacBean is correct

then, assuming MacBean could be counted, there was a quorum present at the June 3, 1944 meeting.

It is true, as defendant states, that in the case of In re Ivey & Ellington, Inc., Del.Ch., 42 A.2d 508, this court recognized the principle of amendment of corporate by-laws by a course of conduct inconsistant therewith. Clearly, however, one who contends that a written by-law has been amended by custom inconsistent therewith has the burden of establishing the existence of such a custom. Upon the undisputed facts, the defendant MacBean has failed to meet this burden, and it is not apparent that facts which would vary such a conclusion will be available to the defendant at the final hearing.

Almost dispositive of the defendant's contention as to the amendment by custom is the undisputed fact that *there was no meeting either of the stockholders or directors between June 30, 1940 and June 3, 1944.* The June 30, 1940 date of course represents the expiration date of the Ware-Wasson agreement, and clearly the by-law provision as to directors would not have been changed prior to that date, because the by-law provision was amended to increase the number of directors from seven to ten in order to effectuate in part the Ware-Wasson agreement. From June 30, 1940 to the directors' meeting date of June 3, 1944—when the issuance of the stock in question was allegedly authorized—no stockholders' meetings or directors' meetings were held. I cannot conceive how total stockholder and director inaction can form the basis for a custom inconsistent with a written by-law provision.

Obviously, if there was no meeting during the period mentioned, then defendant's assertion that directors owning the majority of the stock participated in directors' meetings, and thereby amended the by-law, can have no force, even if we assume that less than total stock representation may be sufficient. This is necessarily so because the directors' meetings where such stock was represented were held *after* the meeting of June 3, 1944, when the issuance of the stock in question was allegedly authorized. Defendant does not contend that the amendment by custom took place subsequent to the June 3, 1944 meeting. Moreover, the defendant MacBean's own actions at a meeting held March 28, 1945 reveal that he did not then consider that the by-laws had theretofore been amended by custom so as to provide for only seven directors. This is so because MacBean at that meeting "advised the meeting that three Directors should be elected to fill the present vacancies in the Board." Since there were admittedly seven directors in office in March of 1945, it is clear that the defendant MacBean assumed the written by-law providing for ten directors was still in effect.

Much reliance is placed by the defendant on the case of In re Ivey & Ellington, Inc., supra, but beyond recognizing the principle that a by-law may be amended by a custom inconsistent therewith, it gives little solace to the defendant. In the first place, the acts relied upon in the Ivey & Ellington case were necessarily inconsistent with the written by-law, because more directors were elected than were provided for by the by-laws, while here fewer directors were elected than were called for in the written by-law. Moreover, in the Ivey & El-

lington case, the inconsistent acts, i. e., attending directors' meetings were participated in by directors who owned all the corporate stock which possessed the right to amend the by-laws. As stated, such was not the case here. Even when confronted with such inconsistent acts, the Chancellor refused to conclude that the written by-law had been amended by custom to the contrary. While the Ivey & Ellington case recognized that the question of whether or not a by-law has been amended by custom inconsistent therewith is largely one of fact, nevertheless, it is apparent from undisputed facts here that the burden of showing such a custom has not been met.

I conclude, therefore, that at the June 3, 1944 meeting no quorum of the directors was present because a majority of the 10 directors required under the by-laws was not present. As a consequence, the resolution authorizing the issuance of the 75,000 shares of the complainant's stock to the defendant MacBean was in the language of this court in Mecleary v. John S. Mecleary, Inc., et al., 13 Del.Ch. 329, 332, 119 A. 557, 559, "illegal, because there was no *quorum* of the board present at the meeting authorized to transact business for the corporation." * * *

BENINTENDI et al v. KENTON HOTEL, INCORPORATED et al.

Court of Appeals of New York, 1945. 294 N.Y. 112, 60 N.E.2d 829.

DESMOND, JUDGE. * * * The by-law numbered 3 [That no action should be taken by the directors except by unanimous vote of all of them] in our list above makes it impossible for the directors to act on any matter except by unanimous vote of all of them. Such a by-law, like the others already discussed herein, is, almost as a matter of law, unworkable and unenforceable for the reason given by the Court of King's Bench in Hascard v. Somany, 1 Freeman 504, in 1693: "primâ facie in all acts done by a corporation, the major number must bind the lesser, or else differences could never be determined." The directors of a corporation are a select body, chosen by the stockholders. By section 27 of the General Corporation Law, the board as such is given the power of management of the corporation. At common law only a majority thereof were needed for a quorum and a majority of that quorum could transact business. Ex parte Willcocks, 7 Cow. 402, 17 Am.Dec, 525. Section 27 modifies that common-law rule only to the extent of permitting a corporation to enact a by-law fixing "the number of directors necessary to constitute a quorum at a number less than a majority of the board, but not less than one-third of its number." Every corporation is thus given the privilege of enacting a by-law fixing its own quorum requirement at any fraction not less than one-third, nor more than a majority, of its directors. But the very idea of a "quorum" is that, when that required number of persons goes into session as a body, the votes of a majority thereof are sufficient for binding action. See for example, Harroun v. Brush Electric Light Co., 152 N.Y. 212, 46 N.E. 291, 38 L.R.A. 615, as to a quorum of the Appellate Division. Thus, while by-law No. 3 is not in explicit terms

forbidden by section 27, supra, it seems to flout the plain purpose of the Legislature in passing that statute. We have not overlooked Section 28 of the General Corporation Law, the first sentence of which is as follows: "Whenever, under the provisions of any corporate law a corporation is authorized to take any action by its directors, action may be taken by the directors, regularly convened as a board, and acting by a majority of a quorum, except when otherwise expressly required by law or the by-laws and any such action shall be executed in behalf of the corporation by such officers as shall be designated by the board." Reading together Sections 27 and 28 and examining their legislative history (see L.1890, Ch. 563; L.1892, Ch. 687; L.1904, Ch. 737), we conclude that there never was a legislative intent so to change the common-law rule as to quorums as to authorize a by-law like the one under scrutiny in this paragraph. A by-law requiring for every action of the board not only a unanimous vote of a quorum of the directors, but of all the directors, sets up a scheme of management utterly inconsistent with Section 27 and 28. * * *

(b) *Authority of Officers.*

JOURDAN v. LONG ISLAND RAILWAY COMPANY

Court of Appeals, New York, 1889. 115 N.Y. 380, 22 N.E. 153.

Appeal from supreme court, general term, second department.

Action by James Jourdan, receiver of the Brooklyn, Flatbush & Coney Island Railway Company, against the Long Island Railroad Company. Judgment was rendered by circuit court on a verdict in favor of plaintiff, and was affirmed by general term. Defendant appeals.

DANFORTH, J. This action was begun in November, 1884, to recover damages from the Long Island Railroad Company for breach of a written contract, purporting to have been made on the 31st day of May, 1879, between the Brooklyn, Flatbush & Coney Island Railway Company, of the first part, Thomas R. Sharp, as receiver of the property, etc., of the Long Island Railroad Company, of the second part, the Long Island Railroad Company, of the third part, and the Atlantic Avenue Railroad Company of Brooklyn, of the fourth part. It was by its terms to continue for a period of five years from its date. The Brooklyn, Flatbush & Coney Island Railroad Company and the Long Island Railroad Company were severally the owners and operators of railways; and, so far as is material to any question calling for our discussion, the terms of the contract were such that the first-named company was required to extend and maintain its track at its own expense, but in a manner satisfactory to the other company, from its then terminus at Bedford Station, so that it should connect with the tracks of the Long Island Railroad Company on Atlantic avenue, and thus form continuous lines of double-track railroad between the depots of that company at Flatbush avenue and East New York, and the depot of the Brooklyn, Flatbush & Coney Island Railway Company at Brighton Beach, on Coney Island, and, as it pleased run trains over

the lines so made continuous between Flatbush avenue and Brighton Beach. The Long Island Railroad Company, and Sharp, its receiver, agreed to furnish it with "all necessary depot facilities for its trains and passengers" at Flatbush avenue, and through its agents sell the tickets at that place; and the party of the first part agreed to pay to the Long Island Railroad Company in compensation "for the use of its tracks, the sale of its tickets and for depot facilities, twenty per cent. of all moneys earned by it for the transportation of passengers between Flatbush avenue and any and all points on the line of the party of the first part south of Bedford Station." * * *

The questions at issue concern only the plaintiff, who represents the party of the first part in the agreement, and the defendant, the Long Island Railroad Company. The alleged breach consisted, in substance, of the failure of the defendant's receiver and its own subsequent refusal, to run the trains of the Long Island Railroad Company over a certain portion of the plaintiff's road, as provided by the contract, and their omission to furnish depot facilities, as also therein provided. Issue was taken upon these allegations and a trial had. At the close of the evidence the defendant's counsel moved the trial judge to dismiss the complaint on the ground that the evidence was insufficient to show a contract between the plaintiff and defendant. The motion was denied, and the case submitted to the jury upon both issues. Their verdict was for the plaintiff, and it has been approved both by the trial judge in denying the defendant's motion for a new trial, and by the general term in affirming the order and the judgment entered upon the verdict.

The defendant's contention is that the contract was not binding upon it. It was, as is conceded, executed in the name of the corporation by its president and secretary. It was sealed with its corporate seal, affixed by its proper officers. It was therefore presumptively valid, and was binding upon the corporation until evidence to the contrary should be produced. If the seal was obtained fraudulently, or the officers acted without authority, either in executing the contract in their official character or in affixing the seal, it lay with the defendant to establish those facts. The evidence adduced for that purpose was from the secretary. He testified that the contract was drafted in pursuance of negotiations between the two companies and the draft was in "his office." An emergency arose, which called for its completion, and he, after consulting with Sharp, the president, with him signed, sealed, and delivered it. "I expected," he says, "to get a ratification." Both of these officers were also directors, and the witness says, "I intended to call the board's attention to it, but forgot it." The court committed no error in refusing to dismiss the complaint, or in refusing to charge the jury that the contract was not binding upon the company. Sharp, the president, was not examined upon that point, and whether the officers of the company did in fact exceed their authority, might have been, under the evidence, a question for the jury. No request was made to submit it. There was, however, abundant and conclusive evidence that the contract was adopted and ratified by the defendant in its corporate capacity. It was, as the secretary and counsel of the defendant testified, drafted in pursuance of negotiations had

between the parties. It was acted upon by the defendant in the management of its business. For one year the defendant complied with its terms, and received for the entire period the benefit of a faithful performance on the part of the other contracting party. It necessarily affected the running of plaintiff's trains and the management of the business for which it was incorporated. As summarized by the learned counsel for the appellant, "it gave rights to another corporation [the plaintiff] to use the tracks and depots of the Long Island Railroad Company, and provided for a division of earnings;" and it is impossible to suppose that these things were suffered or enjoyed without full corporate knowledge of the contract obligations by which they were provided for. Moreover, the defendant received a pecuniary benefit under the contract, upon the assumption that the contract was valid. If they intended to disavow it, it was their duty to be active in so doing and not remain willfully passive, in order to profit by an omission or mistake on the part of their own officers, and which they might have prevented. The appellant argues that the object of the parties might have been attained by two contracts as well as by one, and therefore the defendant is at liberty to adopt so much as makes for its benefit, and reject the rest. It may be that two separate contracts could have been framed in such manner as to meet the views of the parties, and in that case one might have been rejected at the party's risk, and the other performed; but only one was prepared, and that recites that, "in consideration of the mutual covenants and agreements" therein "contained," the parties have agreed and do agree as therein expressed. The provisions are reciprocal. One party can not say, "I have got all I bargained for," and, without liability, repudiate the mutual obligation which enabled it to do so, and formed the consideration of the bargain. One promise was the consideration for the other, and together they constituted a binding agreement. If in fact the formal execution of the contract was unauthorized, it is plain the agreement was one the company had power to make, one which they intended to make, supposed they had made, and which with knowledge, or full means of knowledge, of its terms, they acquiesced in, and ratified, by acting under it so long as it was profitable, and refusing to do so only when it seemed otherwise, but receiving the benefit of it at all times. It is now argued that the question of ratification should have been passed upon by the jury. It is a sufficient answer that no request was made to have it submitted to them; but it may be further said that upon that point the evidence was all one way, and conclusive in the highest degree. We find no legal merit in either of these points.

The other questions raised by the appellant have been examined. So far as they require particular observation, the remarks of the general term are sufficient. We find none which requires other discussion. Upon the assumption that the contract bound the defendant, the plaintiff's way was clear, and his right to a recovery certain. The reasonableness of the amount actually given to him is not for us to determine. The judgment appealed from should be affirmed. All concur.

JOSEPH GREENSPON'S SONS IRON & STEEL COMPANY v. PECOS VALLEY GAS COMPANY

Superior Court of Delaware, 1931. 4 W.W.Harr. 567, 156 A. 350.

Action by Joseph Greenspon's Sons Iron & Steel Company against the Pecos Valley Gas Company.

Instructions to the jury.

RODNEY, J., charging the Jury. This is an action by Joseph Greenspon's Sons Iron and Steel Company, a corporation of the State of Missouri, the plaintiff, against the Pecos Valley Gas Company, a corporation of the State of Delaware, the defendant, to recover a sum of money which the plaintiff claims is due it by reason of the alleged breach of a contract.

The plaintiff claims that the defendant, on the 7th day of January, 1929, agreed to buy from it 45 miles of 6⅝" gas pipe at the sum of 61 cents a foot. The pipe was not delivered. * * *

A corporation is an artificial being created by law and acting under the authority of law for designated purposes. Being artificial and the mere creature of the law, it can only act by its officers and agents. Its officers are its agents or rather the agents of those who compose the corporation and many of the principles of law applicable to the relationship of principal and agent apply to the question of powers of a corporate officer. The precise question here involved is whether a corporation is bound by the contract or writing of the President alone where it involves a contract for 45 miles of pipe at 61 cents a foot involving the expenditure of $144,936.00, without express authority from the Board of Directors. * * *

The powers of a President of a corporation, i. e., the powers over its business and property, are, of course, merely the powers of an agent, for a corporation can speak in no other manner. The control over the company's business and property is vested in the Board of Directors, but subject to this control certain powers are delegated by implication to certain officers. Corporations have assumed and acquired such a position in the business world that the office of President carries with it certain implied powers of an agency. He is usually either expressly or by implied consent made the chief executive officer, without special authority or explicitly delegated power he may perform all acts of an ordinary nature which by usage or necessity are incidents to his office and by virtue of his office he may enter into a contract and bind his corporation in matters arising from and concerning the usual course of the corporation's business. These are the implied powers of the President of a corporation and they inhere in him by virtue of the position itself. Beyond these powers—beyond the carrying out of the usual and proper functions of the corporation necessary for the proper and convenient management of the business of the corporation, the President remains as any other Director of the company, and other and further powers must be specifically conferred.

The plaintiff contends that the action of the President in ordering the pipe was an ordinary and usual duty and within the powers impliedly placed by the law in a President who is also managing execu-

tive of a corporation. Whether or not this is true in any given case depends upon all the facts of the case, including the character of the goods ordered, the amount thereof in relation to the size and condition of the company, the nature of the company, its purposes and aims, and upon many other facts and circumstances. Whether or not a specific action of a President is within his usual duties is, therefore, a question of fact for the determination of the jury.

The powers of a President of a corporation in excess of those hereinbefore suggested, that is, in excess of power over the ordinary and usual business of the corporation, must be specifically given, and the following are the usual sources of this grant of power:

1. Some provision of statutory law;
2. Corporate charter;
3. Some by-law of the company;
4. Resolution of the Board of Directors.

I am referred to no appropriate statute, charter provision or Resolution of the Board of Directors conferring additional power on the President. Section 12 of the By-laws has been admitted into evidence covering the powers of the President. It provides as follows:

"The President shall be the chief executive officer of the company; he shall preside at all meetings of the directors; he shall have general and active management of the business of the company; he shall see that all orders and resolutions of the Board are carried into effect; he shall execute all contracts and agreements authorized by the Board; he shall keep in safe custody the seal of the company and when authorized by the Board affix the seal to any instrument requiring the same and the seal when so affixed shall be attested by the signature of the Secretary or the Treasurer.

"He shall sign all certificates of stock and checks for the payment of money.

"He shall have general supervision and direction of all other officers of the company and shall see that their duties are properly performed.

"He shall submit a report of the operations of the company for the fiscal year to the Directors at their first regular meeting in each year and to the stockholders at their annual meeting and from time to time shall report to the Directors all matters within his knowledge which the interests of the company may require to be brought to their notice.

"He shall be ex officio a member of all standing committees and shall have the general powers and duties of supervision and management usually vested in the office of the President of a corporation."

This you will consider in the solution of the present question.

A fifth and perhaps the most usual source of the grant of the unusual or extraordinary powers of a President arises by implication of law from a course of conduct on the part of both the President and the corporation showing that he had been in the habit of acting in similar matters on behalf of the company and that the company had authorized him so to act and had recognized, approved and ratified his former and similar actions.

As said in Stokes v. New Jersey Pottery Co., 46 N.J.L. 242:

"There are cases in which the powers of an officer of a corporation, and his authority to act for the company, are enlarged beyond those powers which are inherent in his office. But those are cases in which the agency of the officer has arisen from the assent of the directors, presumed from their consent and acquiescence in permitting the officer to assume the direction and control of the business of the company. * * * Thus, when, in the usual course of the business of a corporation, an officer has been allowed in his official capacity to manage its affairs, his authority to represent the corporation may be implied from the manner in which he has been permitted by the directors to transact its business. * * * These are simply instances of the application of the principle that usual employment is evidence of the powers of an agent, and a responsibility will be laid upon the principal for the acts of his agent within the apparent authority so conferred upon the agent—a doctrine which has come to be applied to corporations in many respects as well as to individuals, and with the same qualifications and limitations. * * * In such cases, the authority of the officer does not depend so much on his title, or on the theoretical nature of his office, as on the duties he is in the habit of performing." * * *

Summarizing and in conclusion I say to you that if you should find from the evidence that the contract of January 7, 1929, was a plain unconditional contract to be effective without further or other approval, and that the President, Albert T. Woods, who signed the same, was either acting in the usual scope of his duties or had been in the habit and custom, with the knowledge and approval of the Board of Directors, of so acting alone on behalf of the company, or that the action of the President was afterwards ratified and approved, and should further find that all the agreements of the parties with regard to the financing of the company have been duly and regularly complied with, then your verdict should be for the plaintiff.

If, however, you should find from the evidence that the agreement of January 7, 1929, was conditional upon the obtaining the signature of Mr. Burkett, and was so understood by the parties, and that such consent was never obtained, and shall find that such contract was not afterwards ratified or confirmed, then your verdict must be for the defendant.

Your verdict must also be for the defendant if you should find that Albert T. Woods had no right or power to bind the corporation by the contract and had not theretofore so acted alone for the corporation; or that the conditions of the contract with relation to financing the corporation have never been complied with, within the agreement and understanding of the parties.

If your verdict should be for the plaintiff, it should be for such sum as you shall find from the evidence that the plaintiff has been damaged by the alleged breach of the defendant, not exceeding the amount claimed by the plaintiff.

The measure of this damage would be the difference between the contract price, that is, the price the plaintiff was to have received for the pipe and the market price at which the plaintiff could have obtained the pipe. This difference would represent the amount of his prospective profit.

If your verdict should be for the defendant, it should simply be, verdict for the defendant.

(1). EXPRESS AUTHORITY

JACOBUS v. JAMESTOWN MANTEL COMPANY.

Court of Appeals of New York, 1914. 211 N.Y. 154, 105 N.E. 210.

Action by Warren Jacobus against the Jamestown Mantel Company. From a judgment of the Appellate Division (149 App.Div. 356, 134 N.Y.Supp 418), affirming a judgment for defendant, plaintiff appeals. Affirmed.

CHASE, J. This action is brought on a promissory note, of which the following is a copy: "2,500.00. New York, Oct. 8, 1909. Six months after date we promise to pay to the order of ourselves, Two thousand five hundred & 00/000 dollars at Newton Trust Co., Newton, N. J., value received. Jamestown Mantel Co. Geo. M. Turner, Treas." Said note was indorsed "Jamestown Mantel Co., Geo. M. Turner, Treas.," and it was thereafter delivered to and discounted by the Newton Trust Company, the assignor of the plaintiff. It is the last one of a series of like notes, the original of which was given in August, 1907. At the times herein mentioned the trust company had an investment committee consisting of Hough, its president, Searing, its vice president, and George, a director. Searing and George were partners doing business in New York City. In August, 1907, Searing was the president of the Delaware & Eastern Railroad Company. One Welch, an attorney at law, had done business as such for said railroad company and for Searing individually. Welch asserted that the railroad company and Searing owed him considerable money for services; he told Searing that he needed money for his immediate use, and Searing said to him that the company was not in a position to pay him at that time, but that if he would borrow a note from somebody for a short time, he, Searing, would have it discounted at one of his trust companies. Welch went to Turner and told him that he wanted to borrow a note of the Jamestown Mantel Company for $2,500 to have it discounted, and that if he, Turner, would furnish him with such a note he would take care of it when it was due. Turner in the name of the mantel company, and in the form shown, made and indorsed a note for $2,500, and gave it to Welch. Welch delivered it to Searing, who sent it to the trust company, and received in return for it a draft of $2,425, being the amount of the note less the discount thereon. Searing retained the proceeds of the draft and told Welch that his trust companies were not in funds to discount the note. Before the note became due, however, Searing told Welch that the note had been actually discounted, and that he had used the money. It was thereafter renewed from time to time until the note now in suit became due, when further renewals were refused by the mantel company, and it also refused to pay the note. The defendant was in no way directly or indirectly interested in the transaction. The note was given in its name wholly without authority. If Searing was acting for and on behalf of the trust company, it is of course chargeable with his knowledge that the note

was borrowed for discount to accommodate Welch and Searing, and the defendant is not liable thereon. If he was not acting for and on behalf of the trust company, then he was acting independently of it, and the trust company is in no way chargeable with his knowledge or information.

The first question for consideration on this appeal is whether the knowledge of Searing, under the circumstances disclosed, is attributable to the trust company. We think not. * * *

The defendant is a domestic manufacturing corporation. A corporation is an artificial entity, having only such powers as are given to it by law, and such implied powers as are necessary to the exercise of the powers expressly given to it. The defendant was organized to "manufacture wood mantels, interior finish, bank, office and bar fixtures and generally to carry on any manufacturing business which can conveniently be carried on in conjunction with any of the matters aforesaid." The treasurer of the defendant corporation had no express authority by its by-laws or otherwise to sign or indorse a promissory note. The president of the trust company had never had a transaction with the defendant corporation, and did not know its treasurer. He does not remember that Searing said anything to him whatever at the time the note was sent to him for discount. It was taken by him on behalf of the trust company without inquiry either as to the responsibility of the corporation or as to the authority of its treasurer to make a promissory note even in the usual course of its business. It affirmatively appears, as we have seen, that the treasurer had no express authority to make a promissory note, and that the note as made was not made in the regular transaction of the business of the corporation, but wholly as an accommodation to a friend of such treasurer.

A manufacturing corporation has no power to make or indorse notes for the accommodation of others. National Park Bank of N. Y. v. Ger. Am. M. W. & S. Co., 116 N.Y. 281, 22 N.E. 567, 5 L.R.A. 673; Fox v. Rural Home Co., 90 Hun, 365, 35 N.Y.S. 896, affirmed, on opinion below, 157 N.Y. 684, 51 N.E. 1090. One who deals with the officers or agents of a corporation is bound to know their powers and the extent of their authority. Alexander v. Cauldwell, 83 N.Y. 480. Notwithstanding the general rule stated, a corporation is bound if it makes or indorses commercial paper for the accommodation of another in respect to a bona fide holder who discounts it before maturity on the faith of its being business paper. Mechanics' Banking Association v. N. Y. & S. White Lead Co., 35 N.Y. 505. The decision in the White Lead Co. Case, supra, and other similar decisions are based upon the assumption that the officers making or indorsing a promissory note had authority from the corporation to make and indorse such notes in the ordinary course of its business. Such decisions do not apply to a case where the officers purporting to act for a corporation do not have authority to sign commercial paper in the ordinary course of its business. A treasurer of a manufacturing corporation has no power to make promissory notes in its name unless such power is expressly given to such officer by the by-laws of the corporation or by resolution of its board of directors. [Citing cases.] * * * No presumption existed that the defendant's treasurer had power to

make or indorse business paper. It was necessary, therefore, for the plaintiff to show that the treasurer had authority to execute promissory notes in the name of the corporation in the ordinary course of its business, or that the defendant was estopped from denying such authority.

It is urged that there is some evidence that the treasurer of the defendant had on one or more occasions signed a promissory note in its name in the regular course of defendant's business, and that such note or notes had thereafter been paid by the corporation. It does not appear that said treasurer had ever signed such a note prior to the execution of the note which was given in August, 1907. Whether he had done so or not is of little importance for the purpose of creating an estoppel against the defendant because it affirmatively appears that the trust company did not know of any of the acts claimed to have been done by the defendant's treasurer in its name. * * *

The judgment should be affirmed, with costs.

(2) IMPLIED AND APPARENT AUTHORITY

SHERMAN and another v. FITCH

Supreme Judicial Court of Massachusetts, 1867. 98 Mass. 59.

For some time prior to January 19, 1865, the respondent had been, and then was, selling agent of the corporation, which owed him about eighteen thousand dollars, to secure the payment of which by the corporation, George R. Sampson, who was president and a director, and was also manager of the manufacturing department, executed and delivered to him the instrument in question. At that date there were four directors (who were the principal stockholders): Sampson; his son; a nephew; and one Tappan, who was in Europe. That was the full number of the board required by the by-laws, which also provided that "the board of directors shall manage and control the business, property and affairs of the corporation." The records of the corporation contained no express vote of either directors or stockholders authorizing the execution and delivery to the respondent of a mortgage on the corporate property; but the execution and delivery of the instrument was known to all the directors except Tappan, at the time thereof, "and was approved by them, provided their neglect to make any objection to the same can be construed as an approval." "Neither the corporation nor its directors ever repudiated said alleged mortgage," and on February 13, 1866, the stockholders voted "that all contracts, agreements, and other acts, of the president and directors of the corporation, be and the same are hereby ratified and confirmed." The instrument was recorded with the city clerk of Boston, June 10, 1865. On April 10, 1866, a warrant under the insolvent laws was issued against the corporation, and its property was assigned to the complainants on April 24.

WELLS, J. The question submitted to us is whether the instrument of which a copy is annexed to the plaintiff's bill is a valid mortgage of its property by the "Northampton Street Sugar Refinery." The instrument itself is incapable of any other construction than as the mortgage of the corporation. It names the corporation as the party mak-

ing it; describes the machinery as upon the premises, and in the use and ownership of the corporation; provides for payment by the corporation, and continued possession of the property until default. It is, upon its face, the contract of the corporation, and cannot be made the contract of Sampson by any form of signature whatever. Kingman v. Kelsie, 3 Cush. 339. Jefts v. York, 4 Cush. 371.

The signature "Geo. R. Sampson, President of the Northampton Street Sugar Refinery," is consistent with this construction, and, in form, is a good execution by the corporation of a simple contract. * * *

The remaining consideration relates to the authority of Sampson to execute the mortgage in behalf of the corporation. It is not necessary that the authority should be given by a formal vote. Such an act by the president and general manager of the business of the corporation, with the knowledge and concurrence of the directors, or with their subsequent and long continued acquiescence, may properly be regarded as the act of the corporation. Authority in the agent of a corporation may be inferred from the conduct of its officers, or from their knowledge and neglect to make objection, as well as in the case of individuals. Emerson v. Providence Hat Manufacturing Co. 12 Mass. 237. Melledge v. Boston Iron Co. 5 Cush. 158. Lester v. Webb, 1 Allen, 34. The absence of one of the directors in Europe could not deprive the corporation of the capacity to act and bind itself by the acts of the officers in actual charge of its affairs.

If the validity of the mortgage were to depend entirely upon subsequent ratification, such ratification would be effective notwithstanding the recording of the mortgage. No new record would be necessary. The ratification relates back.

The validity of the mortgage as affected by the insolvent laws is not submitted to us by the case reserved; and, as no provision is made for the ultimate disposition of the case, it must stand for further hearing upon the questions of fact raised by the answer.

MOSELL REALTY CORPORATION v. SCHOFIELD

Supreme Court of Appeals of Virginia, 1945. 183 Va. 782, 33 S.E.2d 774.

Action by Dora Schofield, trading as Schofield & Herman, against the Mosell Realty Corporation to recover for services as a broker in procuring a purchaser for defendant's real estate. To review a judgment for plaintiff, defendant brings error.

Reversed and final judgment entered for defendant.

EGGLESTON, JUSTICE. Dora Schofield, trading as Schofield & Herman, a licensed real estate broker, has recovered a verdict and judgment against Mosell Realty Corporation for services as a broker in procuring purchaser for the corporation's real estate. We are asked to reverse the judgment on the ground that the evidence is insufficient to sustain the verdict and the judgment. The main contention is that the president of the corporation, with whom the contract sued upon was alleged to have been made, lacked the necessary authority to enter into it.

In view of the jury's verdict, the facts may be stated thus:

Mosell Realty Corporation is a close corporation. The capital stock is distributed equally among Sol Kaplan, L. H. Goldman, and Leon Banks, who are its only directors. Kaplan is the president, Goldman the vice-president, and Banks the secretary and treasurer.

The corporation owns a valuable piece of property located at the southeastern corner of Colonial avenue and Thirteenth street, in the city of Norfolk, on which are located a moving picture theatre and four stores. This is the only property the corporation owns or has ever owned. All of the buildings are occupied by tenants and the leases were arranged through Banks, who is engaged in the real estate rental business in Norfolk and who attends to the collection of the rents and the matters incidental thereto. Kaplan likewise lives in Norfolk, while Goldman lives at Durham, North Carolina. * * *

On June 28, 1943, Herman obtained from one D. Galanides a written offer to buy the property at the sum of $51,000. The offer was accompanied by a deposit of $500. Herman presented the offer and check to Kaplan who examined and approved them but requested that Herman hold them, saying that he (Kaplan) was leaving for New York that afternoon. Kaplan further said that upon his return "I will accept the offer." Herman called upon Kaplan upon the latter's return from New York. In the meantime Herman had obtained a written offer from Harry Kramer, accompanied by a deposit of $500, to purchase the property at $52,500. Herman presented both the Galanides and Kramer offers to Kaplan who refused to accept either, because he said that on his trip to New York he "happened to see Goldman" who informed him (Kaplan) that he (Goldman) was not willing to sell the property.

Kaplan denied having made this statement to Herman as to the interview between him (Kaplan) and Goldman in New York. He testified that no such interview took place. Goldman likewise testified that there was no such interview or conversation, and that the first intimation he had about the negotiations for the sale of the property was contained in a letter to him from Banks after the present suit had been brought. Indeed, Goldman said, the subject of the sale of the property at any price had never been discussed by Kaplan, Banks and himself, who constituted the board of directors and were the holders of all of the capital stock of the corporation.

Banks, the secretary and treasurer of the corporation, testified that the corporation had authorized no one to sell the property.

While counsel for both parties indicated at the trial that they desired to offer in evidence the minute books of the corporation, so far as the record shows they were not produced. Apparently the corporation held only the formal annual meetings of its board of directors. Goldman admitted that he received notice of such meetings, but the record is silent as to whether he attended them.

Although the record discloses no formal resolution of the board of directors or stockholders authorizing Kaplan, its president, to sell this property, which, as has been said, was the corporation's principal asset, or to enter into the brokerage contract to effect such a sale, the defendant in error contends that such authority is sustainable on two theories;

First, Kaplan, as president of the corporation, had the implied or inherent authority to enter into the contract sued on; and, second, the directors of the corporation clothed him with the apparent authority to enter into the contract sued on, and hence they and the corporation are estopped to deny the lack of actual authority therefor. In our opinion, neither of these contentions can be sustained.

It is well settled that the inherent or implied authority of a corporate president is limited to acts within the ordinary course of its business and does not extend to extraordinary and unusual transactions such as the sale and purchase of real estate. * * *

In Sterling v. Trust Company of Norfolk, 149 Va. 867, 141 S.E. 856, this court held that the secretary and treasurer of a corporation engaged in the automobile and garage business did not have the authority to bind the corporation for the purchase of an expensive piece of real estate for the purpose of enlarging its business, even though such officer held approximately fifty per cent. of the capital stock of the corporation, was one of its three stockholders, and one of its four directors. We there pointed out (149 Va. at pages 877, 878, 141 S.E. at pages 858, 859) that such authority was lodged in the board of directors of the corporation.

The same principles apply to the sale of a corporation's real estate. If a corporate president is without implied authority, by virtue of his office, to sell a part of the real estate of the corporation, a fortiori he is without implied power to negotiate a sale of the real estate which, as here, constitutes the corporation's principal asset. Fletcher Cyclopedia Corporations, Perm. Ed., Vol. 2, § 606, pp. 515, 516.

Neither do we think that the verdict and judgment here can be sustained under the principle that the corporation clothed its president with apparent authority to enter into the contract sued on and for that reason is estopped to deny that it actually authorized him to do so.

True it is that, "A corporation is subject, to the same extent as a natural person, to the general principle that one who holds out another, or allows him to appear as having authority to act, as his agent with respect to his business generally, or with respect to a particular matter, cannot, as against persons dealing with him in good faith, deny that his apparent authority is real." Fletcher Cyclopedia Corporations, Perm. Ed., Vol. 2, § 449, p. 257. Sterling v. Trust Company of Norfolk, supra, 149 Va. at pages 879, 880, 141 S.E. 856; Bardach Iron & Steel Co. v. Charleston Port Terminals, 143 Va. 656, 673, 129 S.E. 687.

But as it is aptly said in Restatement of the Law, Agency, Vol. 1, § 52, p. 131, "Unless otherwise agreed, authority to act in the principal's business does not include authority to sell the principal's interests in land, unless the business entrusted to the agent includes the selling of land."

And, continuing, the author says (Vol. 1, § 52, p. 132): "Ordinarily, an authority to conduct a business, no matter how general, does not include authority to sell things necessary for the operation of the business as it is ordinarily conducted. Thus, where the premises upon which a business is conducted are owned by the principal, it is inferred that a manager of the business has no authority to sell them or any

portion of them." See, also, Mechem on Agency, 2d Ed., § 802, p. 576; 2 Am.Jur., Agency, § 140, p. 112.

Let us examine the evidence here in the light of these principles. This corporation owns a single piece of real estate which is the only property it has ever owned. It is not engaged in the business of buying and selling real estate.[25] Its only business is that of leasing the property and such matters as are incidental thereto. This business the corporation entrusted to Banks as its rental agent. Whether the directors, by formal action, authorized this agency we do not know. But even if it did not do so, the board clothed the rental agent with the apparent authority to execute the necessary leases and to do such things as were incidental thereto.

We may assume that Kaplan cooperated with Banks to such an extent that each had the apparent authority to negotiate and execute the leases and to carry out the necessary details, and that Goldman acquiesced there. If so, leasing the property and attending to the matters incidental thereto were the limit of Kaplan's and Banks' authority. The fact that they had the apparent authority, or even the actual authority, to lease the property did not carry with it the implied authority to sell. * * *

It is true that under the testimony on behalf of the plaintiff below the jury had the right to infer that two of the directors of the corporation (Kaplan and Banks) had acquiesced in the contract here sued on. But there is no such evidence as to Goldman, the third director. According to Kaplan's statement, as related by Herman, when Kaplan mentioned the subject of a proposed sale to Goldman, in New York, Goldman immediately expressed his unwillingness to sell the property and thus repudiated the transaction. And yet the effect of the judgment below is to hold Goldman's interest in the corporation liable for one-third of the recovery.

But aside from this, the fact that Kaplan and Banks owned a majority of the stock of the corporation, and constituted a majority of its board of directors, gave them no authority to bind the corporation in any such informal manner.

It is elementary that the authority of the directors is conferred upon them as a board, and they can bind the corporation only by acting together as an official body. A majority of them, in their individual names, cannot act for the board itself and bind the corporation. * * *

As this court, speaking through Mr. Justice Holt, said in Starring v. Kemp, supra, 167 Va. at page 435, 188 S.E. at page 177, "The directors of a corporation must act in their corporate capacity, as a board in orderly procedure, and not as individuals; * * *."

Nor did the fact that Kaplan and Banks own two-thirds of the capital stock of the corporation, in the absence of statute, vest in them the authority to bind the corporation outside of a formal stockholders'

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25 The defendant in error prints as an appendix to her brief the charter of the corporation which lists "the purposes for which it is formed," among others, "to buy, sell, * * * and generally deal in improved or unimproved real properties * * *."

Aside from the fact that the charter was not offered in evidence and hence is not a part of the record, the fact that the corporation was chartered for these purposes is, of course, no evidence that it actually engaged in such business.

meeting. * * *

Since the evidence before us shows that Kaplan, the president of the corporation, lacked the necessary authority to enter into the contract sued on, it follows that the judgment complained of must be reversed and a final judgment entered for the defendant corporation.

Reversed and final judgment.

HOLT and SPRATLEY, JJ., dissenting. * * *

SCHWARTZ v. UNITED MERCHANTS & MANUFACTURERS INCORPORATED.

Circuit Court of Appeals of the United States, Second Circuit, 1934. 72 F.2d 256.

Appeal from the District Court of the United States for the Southern District of New York.

Action by Joseph Schwartz against the United Merchants & Manufacturers, Inc., for breach of contract. From a judgment dismissing the complaint, plaintiff appeals.

Affirmed.

L. HAND, CIRCUIT JUDGE. The action was for breach by the defendant a corporation, of a contract between itself and the plaintiff. The defendant held a majority of the shares of two other companies, the Ashland Corporation and the United Rayon Mills and apparently controlled their affairs; they were textile mills, the defendant was a holding company. The plaintiff had been made the selling agent of the Ashland Corporation, discharging his duties through a company called the Cayuga Silk Corporation which he had organized with one, Holden. The defendant's president, Loring, and its vice-president, Jewett, thought it would be advantageous to substitute another contract in place of this, and long negotiations went on between them and their lawyer, Alexander, on the one hand, and the plaintiff and his lawyer, Frankel, on the other. Various drafts of a proposed contract were submitted and amended, but finally a form was agreed upon which the plaintiff signed and caused to be transmitted to Loring. As the case comes up, we may assume arguendo that Loring also signed it, and told the plaintiff that he could pick it up at any time when he called at Loring's office. A draft of it was in evidence, and as the case turns upon it, we must state it with a little detail. The parties agreed to form a company with a capital of $5,000 of which the plaintiff is to contribute $2,250 and the defendant $2,750; this company is to issue 100 non-par shares, of which the defendant is to receive 55 (Class A), and the plaintiff 45 (Class B); each class to elect two directors. The defendant "agrees and warrants that it will cause the Ashland Corporation to enter into an agreement" by which the new corporation shall become for two years the exclusive selling agent for the Ashland company and for that part of the product of the Rayon Mill which is sold exclusively by the Ashland company. Commissions are fixed on the sales, and the new corporation's operating expenses are in any case to be guaranteed by the Ashland company. In addition the Ashland company is to pay a graduated percentage of the

joint profits of itself and the Rayon company; 25% of the first $100,000, 30% of the next $50,000, 35% of the second $50,000, and 40% of all profits above $200,000. The defendant warrants that such an agreement has been approved by the directors of the Ashland company, and that its president is authorized to make such a contract. The defendant agrees to vote its A shares in the new company to give the plaintiff a salary of $20,000 for two years, and to elect him president; it guarantees the performance of this contract of employment; the new company is to take over a lease of one of the plaintiff's companies and its fixtures at their book value. The defendant repudiated the transaction, insisting that it had not made any contract, and the plaintiff sued. He alleged that Loring's admissions to him established the execution and delivery; that, as president, Loring had prima facie authority to make such a contract; and that if there were no written contract, there was an equivalent oral one. The defendant denied each of these positions and in addition alleged that the contract if ever made, had been rescinded. At the close of the plaintiff's case the judge dismissed the complaint and this appeal followed.

There is no evidence of any sort that the directors of the defendant had ever heard of Loring's and Jewett's negotiations with the plaintiff; certainly none that they knew that he meant to close anything like the written draft upon which the plaintiff relies. Such a contract was by no means matter of course in any business, even assuming that the employment of an exclusive selling agent for a textile mill is a routine affair; itself a hardy assumption, for which there is not the least evidence in the record. Indeed this was not even a contract by a mill to employ its own exclusive selling agent; the defendant, by virtue of its holdings in two subsidiaries proposed to impose a selling agent upon them. It is true that the contract recites that the directors of the Ashland company have already so resolved, and this is an admission against the defendant, if we suppose the contract to have been signed and delivered; but nothing of the sort appears as to the Rayon Mill. The exceptional character of this contract did not however stop there; for the defendant reserved more than half the profits of the agency to itself. Though a majority shareholder in the new company it was to contribute nothing to the services, so far as appears, but a trifling capital and a guarantee of the salary to the real selling agent, the plaintiff. For this it might get more than fifteen per cent. of the earnings of the subsidiaries. We need not hold that this made it inevitably unlawful without the assent of the subsidiaries' minority stockholders; but certainly it was not a customary or usual transaction, even if the employment of an exclusive selling agent is such, or the employment of a selling agent for a subsidiary.

The law as to the prima facie authority of a president or other general officer of a corporation is not very clear. Unquestionably there has been a tendency of late to imply greater authority and to throw upon the corporation the duty of showing that in fact the directors have not authorized the particular powers exercised. The Court of Appeals of New York has indeed twice said without limitation that a president presumptively has any powers which the directors have authority to give him or could ratify, Patterson v. Robinson, 116 N.Y.

193, 200, 22 N.E. 372; Hastings v. Brooklyn Life Ins. Co., 138 N.Y. 473, 479, 34 N.E. 289; though the decisions cited do not support so far reaching a doctrine. In Oakes v. Cattaraugus Water Co., 143 N.Y. 430, 436, 38 N.E. 461, 26 L.R.A. 541, it appeared that the president had full charge of the business and the case really does not stand for the rule. In Watkins Salt Co. v. Mulkey (C.C.A.) 225 F. 739, our decision was to the contrary; but in Hotel Woodward v. Ford Motor Co. (C.C.A.) 258 F. 322, we accepted the presumption without limitation, though it appears from the later report of the same case (C.C.A.) 271 F. 625, that it was unnecessary to the decision. How far it was part of our ruling in Ransome Concrete Machinery Co. v. Moody (C.C.A.) 282 F. 29, is not clear. In the last three cases we were professing to follow New York law, and the Court of Appeals has more recently twice expressly decided that there were limitations on the doctrine. Heaman v. Rowell Co., 261 N.Y. 229, 185 N.E. 83; Powers v. Schlicht H. L. & P. Co., 23 App.Div. 380, 48 N.Y.S. 237, affirmed on opinion below, 165 N.Y. 662, 59 N.E. 1129. How far a similar ruling was involved in Bankers' Trust Co. v. International R. Co., 207 App.Div. 579, 202 N.Y.S. 561; Id., 239 N.Y. 619, 147 N.E. 220, and in Large v. Wire Wheel Corp., 223 App.Div. 134, 227 N.Y.S. 449; Id., 250 N.Y. 531, 166 N.E. 312, it is impossible to say, for the Court of Appeals did not write; but at least the opinions below assumed that not all contracts which the directors may authorize are presumptively within the president's authority. In Hardin v. Morgan Lithograph Co., 247 N.Y. 332, 338, 339, 160 N.E. 338, 390, although Hastings v. B. L. Ins. Co., supra, 138 N.Y. 473, 34 N.E. 289, was quoted, the presumption was limited to "such ordinary contracts as custom and the necessities of business would justify or require." The contract there at bar was not an unusual one; nor was that before the court in Twyeffort v. Unexcelled Mfg. Co., Ltd., 263 N.Y. 6, 188 N.E. 138, where the intimation was not justified that Pound, J., had intended in Hardin v. Morgan Lithograph Co., supra, 247 N.Y. 332, 160 N.E. 388, to adopt the unlimited form. The citation of Peck v. Dexter S. P. & P. Co., 164 N.Y. 127, 58 N.E. 6, in Hardin v. Morgan Lithograph Co., supra, shows that the president's authority does not in this regard differ from that of any other officer.

We conclude therefore that there is no absolute rule in New York that any contract which the president of a company may make, however out of the ordinary, throws upon the company the duty of showing that he was unauthorized. It is true that whatever powers are usual in the business may be assumed to have been granted; but the presumption stops there, as much in the case of a president as of any other officer, though, naturally in degree they may greatly differ. If so, it seems to us apparent that if any contract needed the express authority of the directors it was this. Not only did it commit the subsidiaries to an exclusive selling agent of the holding company's choosing for two years, a thing most vital to their welfare; but on its face it was a violation of the defendant's obligation to the minority shareholders of those companies, whose earnings were to be diverted to the defendant upon an insufficient consideration. Hyams v. Calumet & Hecla Mining Co., 221 F. 529, 537 (C.C.A. 6); Wheeler v. Abilene Nat. Bank, 159 F. 391, 393–395, 16 L.R.A.,N.S., 892, 14 Ann.Cas.

917 (C.C.A. 8); Heim v. Jobes, 14 F.2d 29, 35 (C.C.A. 8). Surely it would be a curious doctrine which assumed without evidence that a president might bind his corporation to such a questionable undertaking, which might involve it in litigation, if indeed it was valid at all. No desire to free plaintiffs from being obliged to fish in their enemies' water ought so far to fly in the face of probability; nothing could justify such a procedure except the express shifting of the duty of going forward upon the party holding the negative.

Judgment affirmed.

MANTON, CIRCUIT JUDGE, dissents in separate opinion. * * *

(c) *Delegation of Authority.*

SMITH et al. v. CALIFORNIA THORN CORDAGE, INCORPORATED et al.

District Court of Appeal of California, 1933. 129 Cal.App. 93, 18 P.2d 393.

Action by Wilburn Smith and others against California Thorn Cordage, Inc., and others, wherein defendant John C. Thorn filed a cross-complaint. From an adverse judgment, plaintiffs appeal.

Reversed with directions.

TUTTLE, JUSTICE. * * * The undisputed facts show that defendant corporation was organized in 1924, for the purpose of manufacturing rope and twine. Defendant Thorn was one of the organizers and promoters of the company, and always took an active and dominant part in its management and affairs. Promotion stock in the amount of 1,632 shares was issued to Thorn, and, under the rules of the state corporation commissioner, were deposited in escrow with National City Bank of Los Angeles. Thorn parted with no monetary consideration when he acquired the stock, it being issued in consideration of services rendered the corporation. On and prior to December 2, 1926, one William Diller was a creditor of said corporation, having loaned to it large sums of money, secured by mortgages upon the real and personal property. These claims were assigned to plaintiff Cassidy, who had filed suit to foreclose said mortgages. During said time plaintiff Smith was a large creditor of the company, and his loans were all overdue and unpaid. Diller and Smith were the largest stockholders so far as actual cash purchases of stock were concerned.

On December 2, 1926, Diller, Smith, and Thorn executed an agreement concerning the affairs of the corporation. This agreement was merged into a second agreement, dated December 16, 1926. It recites that certain differences had arisen between the parties who were stockholders and directors of the corporation, in respect to its financial affairs and management. It is agreed that a finance committee be formed, composed of Diller, Smith, and Lyday, their appointment to be ratified by the directors, and that the by-laws be amended to give said committee the powers necessary to carry into effect the agreement. This committee is empowered to take complete charge and control of the finances of the corporation; to raise funds

for the development of the corporation, either by sale of its capital stock or a bond issue, and to become guarantors upon its notes. Diller agreed, when the directors had ratified the contract, to dismiss all actions brought by him against the corporation. Thorn agreed to resign as general manager and accept a position as director of sales and production. * * * It is provided that, when all the obligations of the company have been discharged, the committee shall "automatically cease to exist and its powers shall thereafter be exercised by the board of directors of said corporation." * * *

The first question to be decided is the legality of the contract of December 16th. The trial court concluded that it was "contrary to public policy, is illegal, null and void." No serious contrary contention is made by appellants. Section 305 of the Civil Code read, when the contract was executed, as follows:

"The corporate powers, business, and property of all corporations formed under this title, must be exercised, conducted, and controlled by a board of not less than three directors, to be elected from among the holders of stock."

A casual reading of the contract at once discloses that it is a bald attempt to usurp the powers and duties of the directors. For instance, the "finance committee" is given "complete charge" of the finances of the corporation; and they are empowered to raise funds by sale of stock or a bond issue, and when the indebtedness of the company has been discharged, they shall cease to function, and their powers "shall thereafter be exercised by the Board of Directors." Agreements of this character have been consistently condemned and held void by our courts, upon the ground that they are contrary to public policy. Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559, Ann.Cas.1918E, 247; Jackson v. Hooper, 76 N.J.Eq. 592, 75 A. 568, 27 L.R.A.,N.S., 659, 664; Farmers' Gin Co. v. Kasch (Tex.Civ.App.) 277 S.W. 746; Haldeman v. Haldeman, 176 Ky. 635, 197 S.W. 376; Teich v. Kaufman, 174 Ill. App. 306. The prerogatives and functions of the directors of a stock corporation are definitely fixed and established by our Civil Code. Section 305 et seq. The effect of this contract would be to withdraw from the directors of the corporation that control and direction of its corporate affairs, business, and management which is vested in them by law and place such control and direction in the hands of three stockholders. Such contracts are clearly illegal and unenforceable in law and in equity. * * *

The judgment is reversed, with directions to the trial court to dismiss the action.

SHERMAN & ELLIS INCORPORATED v. INDIANA MUTUAL CASUALTY COMPANY et al.[26]

Circuit Court of Appeals of the United States, Seventh Circuit, 1930. 41 F.2d 588.

Suit by Sherman & Ellis, Inc., against the Indiana Mutual Casualty Company and another. From an adverse decree, plaintiff appeals. Modified and affirmed.

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26 Cert. den. 282 U.S. 893, 51 S.Ct. 107 (1930).

EVANS, CIRCUIT JUDGE. This appeal is from a decree allowing appellant but a small part of its asserted claim against the Indiana Mutual Casualty Company, here called the Casualty Company. The rejected items are predicated upon the latter company's breach of its contract as well as for moneys advanced by appellant in carrying out said contract. * * *

The casualty company, an Indiana corporation, was organized to take over the business of an unincorporated association engaged largely in writing policies covering risks created by the Indiana Workmen's Compensation Law. It early ratified the agreement here involved with appellant (an Illinois corporation that transacted a large business in casualty insurance), by which agreement the management of the casualty company was conferred upon appellant for a period of twenty years. The compensation for the services thus rendered was agreed upon and specifically stated in the agreement. The casualty company terminated its contract after some difficulties had arisen between appellant and the Indiana state department and after an unsuccessful attempt had been made by the state to have a receiver appointed for the casualty company. This siut to enforce specific performance of the contract and to recover damages followed.

The agreement betweeen appellant and the casualty company provided:

"That for and during a period of twenty years from the date hereof, it will supply without compensation other than the payments specified in Article II, Paragraph First, hereof, the underwriting *and executive management* for the Mutual Company in the person of its President, Frank H. Ellis, or such other of its officers as it may from time to time designate, who shall be competent to perform the services of chief executive head and underwriting manager of the Mutual Company, to the end that the same competent management which the Indiana Manufacturers Reciprocal Association has enjoyed in the past may continue uninterrupted for the benefit of the Mutual Company policyholders.

" * * * That for and during said twenty-year period it will cause to be elected as its underwriting manager, who shall have general supervision and charge of the underwriting affairs of the corporation, such person who shall be an officer of the Management Company as the Management Company shall from time to time by a writing signed by not less than a majority of its Board of Directors designate, provided that if any court of final jurisdiction shall hold that the management shall prove grossly incompetent or inefficient, then this contract shall become null and void."

"The Mutual Company covenants and agrees:

"First: That for and during the said twenty year period it shall set aside for and pay to the Management Company as and when collected by it, ten (10) per cent of the net earned premium collected from all policyholders during said period. This covenant is based upon the assurance of the Management Company that the total Management expense, inclusive of said ten per cent payments to it, but less claim expense as the same has been heretofore calculated under the said power of attorney attached hereto as 'Exhibit A' and less expense of

directors shall not exceed thirty (30) per cent of the said net premiums so collected and if said Management expense during any yearly accounting period shall exceed such latter percentage, the amounts payable to the Management Company for any such period shall be abated by the amount of such excess management cost."

Appellees argue that this agreement is void as against public policy, and therefore its breach created no liability on the part of appellees.

The statutes applicable are sections 9091–9114, Burns' 1926 Statutes.

The by-laws of the casualty company among other things read:

"All officers shall be elected at the annual meeting of the Board of Directors upon the affirmative vote of a majority of the total number of directors.

"The Board of Directors shall have the general control and management of the business of the corporation. Subject to the limitations expressed in Article IX, they shall have the power to make and amend by-laws and make all regulations and take all action necessary or desirable for the proper transaction and conduct of the business and affairs of the corporation. They may appoint an executive committee composed of three or more members of the Board of Directors and delegate to such Committee such of their own powers as they may from time to time deem expedient or proper.

"These by-laws may be amended by the Board of Directors at any regular or special meeting by a two-thirds vote of the entire number of directors but no such amendment shall be effective to impair the rights of any third parties under a theretofore existing contract entered into with the corporation and which was authorized by the provisions of the by-laws as in force at the time of the execution of such contract."

The line of demarcation between cases which recognize the right of officers of a corporation to delegate certain managerial duties to a stranger and cases which deny such authority is not entirely clear or easy to follow. That corporations may, at least for a limited period, delegate to a stranger certain duties usually performed by the officers, is clear. [Citing cases.]

On the other hand, it is equally well settled that there are duties, the performance of which may not be indefinitely delegated to outsiders. [Citing cases.]

The case of Jones v. Williams, 139 Mo. 1, 39 S.W. 486, 40 S.W. 353, 37 L.R.A. 682, 61 Am.St.Rep. 436, is as strong as any that appellant has cited, and illustrates, perhaps as well as any, the extent to which the courts have gone in upholding such delegations of authority. Here the Board of Directors gave an outsider the position of editor and manager of a large daily paper for a period of five years, during which time said outsider was to determine the editorial policy of the paper. But the facts in that case fall short of those presented in the instant suit. The period of control there fixed was five years. Here it is twenty years. There a large part of the board's official duties was undelegated. Here nothing of importance was left for the board of directors but the unimportant, the ministerial duties.

It is true the statutes of most of the states authorizing the organization of corporations are of general application and are easily complied

with. Yet we cannot believe that the requirements therein found or the official duties therein prescribed are mere formalities or only directory in character. This is particularly true of insurance companies upon whose conservative management and financial responsibility a multitude of policy holders are dependent. The grant of corporate power by a state is upon the hypothesis that these powers shall be exercised by the corporation's officers, annually elected, by the stockholders and not by the officers of another corporation. Anglo American Land, etc., Co. v. Lombard, supra.

Reverting to the language of this agreement for a moment, it appears "that for and during the period of twenty years from the date hereof it" (appellant) "will supply * * * *the underwriting and executive management* * * * in the person of its president, Frank H. Ellis, or such other officer as it may from time to time designate," and that "during said twenty-year period" the casualty company shall elect the officer furnished by appellant for its underwriting manager who "shall have general supervision and charge of the underwriting affairs of the corporation."

Such an agreement negatives the thought that appellant was merely the soliciting agent of the casualty company. It contemplated the substitution of appellant for the officers of the casualty company. What was the casualty company's business? To write casualty insurance and adjust the losses growing out of such insurance. If there existed a conflict of opinion between the board and appellant, whose voice under this contract would control? Obviously, appellant's. The length of time during which the agreement was to operate likewise indicated that not only managerial powers were delegated, but the entire policy of the casualty company business was to be fixed and determined by appellant. No other conclusion can be drawn from this agreement and the evidence than that the casualty company was to be merely an instrumentality through which appellant was to conduct a casualty insurance business in the state of Indiana. The agreement which accomplished this result transcends the spirit and theory upon which corporate franchises are based, and is void. * * * As thus modified, the decree is affirmed. The costs in this court will be borne equally.

(d) De Facto Directors and Officers.

PEOPLE'S MUTUAL INSURANCE COMPANY v. WESTCOTT and another.

Supreme Judicial Court of Massachusetts, 1860. 14 Gray 440.

ACTION OF CONTRACT by a mutual fire insurance company, established by Sts. 1847, c. 18, and 1848, c. 312, to recover an assessment or call laid, under the circumstances stated in the opinion, upon a premium note signed by the defendants. Among the by-laws of the company in force in 1854 were these:

"ART. 1. There shall be an annual meeting of this company on the third Monday of January. Seven members shall constitute a quorum.

"ART. 2. Special meetings of this company shall be called whenever the directors may deem it necessary. Notice of all meetings of the company shall be given in two or more newspapers printed in Boston.

"ART. 3. The powers of this company shall be vested in twelve or more directors, who shall elect the necessary officers, fix their compensation and superintend the concerns of the company. Five directors shall constitute a quorum."

HOAR, J. It is evident that the plaintiffs cannot maintain this action, unless the assessment or call made by the vote of September 13th 1854 was lawfully made, and created a valid obligation according to the contract of the defendants.

Previously to June 12th 1854, the by-laws of the company provided that "the powers of the company should be vested in twelve or more directors," and that five directors should constitute a quorum. At the regular annual meeting of the company, held on the 16th of January 1854, twelve persons were chosen directors for the ensuing year, and held their offices on the 12th of June following. On the 12th of June a special meeting of the company was held, in pursuance of a notice duly published, "for the purpose of making alterations in the by-laws, and for the transaction of such business as may come before them." At the meeting thus held, the by-laws were altered by making four directors a quorum instead of five, and seven additional directors were chosen. Four of the seven directors then chosen were the only directors who were present at the directors' meeting held on the 13th of September 1854, by which the assessment was made which is the foundation of this action.

It has been argued for the defendants that these were not directors of the company; that their action in the premises was not authorized by law; and that the claim made upon the defendants, by virtue of it, cannot be supported. The St. of 1854, c. 453, § 15, provides that "every mutual insurance company shall annually elect, by ballot, not less than seven directors," who "shall manage and conduct the business thereof." A similar provision was made in the Rev. Sts. c. 37, § 25; and by § 27, authority was given to fill vacancies by a special election.

The officers thus chosen are chosen for the year succeeding the annual meeting; and the point is certainly deserving grave consideration whether the power of the corporation to choose them is not exhausted, when, at an annual meeting, a number of directors, not less than the number required by law have been elected. If the number to be chosen is not fixed by the by-laws, then the determination and choice of a particular number at the annual meeting might be regarded as having the effect to fix it for the ensuing year; and there is no express authority given by statute to choose directors at any other time, unless to fill a vacancy.

But a decisive objection to the choice of these new directors is, that in the call for the meeting at which they were chosen there was no intimation of any purpose to make such an election. The only specific subject of action named was the alteration of the by-laws. There was no by-law limiting the number of directors, and no new by-law

was adopted respecting the number to be chosen, or altering the time of holding the annual meeting. A measure of such importance to the members of the company, which might transfer the whole corporate power to new hands, could not fairly be embraced in the phrase "for the transaction of such business as may come before them."

It is urged on behalf of the plaintiffs that these were directors *de facto,* actually holding and exercising the office at the time the assessment was made, and that it is not open to the defendants to object collaterally to the legality of their election. But we think the doctrine of the validity of acts done *colore officii,* although well established by the authorities cited, is not applicable to this case. In Baird v. Bank of Washington, 11 S. & R. 411, which is the case most relied on, a director of the bank was chosen at a meeting at which less than a quorum were present; and it was held, that his acts as an agent and officer of the bank were valid, as between the bank and third persons. But these defendants are not to be regarded as third persons in their relation to the insurance company. They are not debtors absolutely to the corporation. By the terms of their contract, their liability can only be created by an assessment or call made by the directors, officers in whose selection they are entitled to a voice. The directors referred to in their contract were the twelve who were chosen at the annual meeting, and who held the office on the 13th of September 1854. No vote to increase the number had been passed at any meeting held for such a purpose. They were not bound to recognize as directors persons who were never lawfully chosen, and who were usurping the functions of an office already filled.

Judgment for the defendants.

2. MANAGEMENT RESPONSIBILITY TO THE CORPORATION

NOTE

STANDARDS OF MANAGEMENT CONDUCT

The area of corporate management is likely to be a field of great legal, and possibly political, activity in the coming generation.

The early experience of corporate management arose out of the small corporation. A few people contributed capital; Directors and officers conducted an enterprise with these assets; they were accountable for themselves to the stockholder or others. The conventional standards of management conduct arose from this and they are repeated in these materials. They are primarily the standards imposed on men accountable for other people's property: the duty of reasonable care, the duty of loyalty and fidelity. They do not greatly vary from the standards mentioned in the Parable of the Talents in the New Testament (Matthew: 25:14).

Yet, as the corporation grows in size, the simple fiduciary standards applied to men dealing with property of others become complicated; and they widen. No longer is a Board of Directors acting for and representative of a single group of shareholders. The shareholders themselves may be completely disinterested. The preferred stockholders are interested principally in security and continuity of return; the common stockholder is interested in large profits and is prepared to take great risks. Even among common stockholders there may be large interests with different ideas and different financial desires; and Directors are commonly chosen to represent large individual or concentrated holdings. For instance, on

the Board of the New York Central Railroad Company, there are Directors representing the remaining holdings of the Vanderbilt family; and others representing the now larger holdings of New York Central stock by the Chesapeake & Ohio Railroad, and its affiliates. The financial interests in the C. & O. may call for a different type of development of the New York Central Railroad than the plans which would appeal to the individual common stockholder. Directors are clearly not representative of all stockholders; in practice, it is humanly impossible for them to disregard the point of view of the particular stockholders responsible for their election.

As the corporation grows, it becomes not merely the business investment of private individuals, but a factor—possibly a decisive factor—in the life of a community, or a region, or possibly even of the entire country. The stockholders look to it for dividends. But thousands of people may also look to it for steady employment; millions of people for goods or services convenient or perhaps essential to their daily lives. In the aggregate, relatively few business concerns play an extremely large part in the economic condition of the country. As concentration of the industrial function grows, and as power is increasingly exercised by a few hundred or less Boards of Directors and similar officials, the management stewardship transcends the simiplicities of pure property accountability.

Enlightened management recognizes this. Indeed, if they failed to do so, the forces of public opinion, easily translatable into political action, would compel them to do so. For example, in a labor controversy, they must consider whether a policy of profitably exploiting labor (yielding greater dividends to their stockholders) would be sound or even permissible if indulged against the plain community need to raise the standard of living of the corporation employees. They may have to consider the propriety of securing additional high profits when the interest of the community (as for instance, in wartime) is plainly to keep prices down to avoid inflationary moves. And so on through the whole gamut of social and economic arguments. The simple arithmetic of property and profits may not yield the sole answer to the management problem. In retrospect, the famous case of Dodge vs. Ford (supra, p. 391) where the strict logic of property was applied, seems not as clear to us as it did to a Michigan court in 1912.

There is little doubt that courts are quite aware of this problem. Yet, so far as formal rules are concerned, the ancient statement of the Michigan court is still classic, and no adequate statement of the newer responsibilities has been formulated. The courts have to act in a twilight zone of their own creation. This is covered by the "presumption" that any action taken by Directors is taken "for the best interest of the corporation"—unless the contrary is proved.

This presumption undoubtedly arises from the desire of courts not to substitute their business judgment for the business judgment of management. It began largely as a rule of protection for courts. As its scope expands, however, the presumption can be indulged to cover actions of management which go beyond pure property arithmetic. Probably additional language indicating that the action may be in the "long-range" interests of the corporation (and therefore within the range of the presumption in favor of the management) can bolster (or perhaps conceal) the willingness of courts consciously to extend the flexibility of management action.

This has distinct advantages; also distinct disadvantages. Liberated somewhat from the narrow arithmetic of property, managements now become the economic supply-line of the country, with recognized responsibility to its labor, consumers and the public. That same latitude, however, could be exercised detrimentally or inequitably against stockholders, labor, the consuming public, or the economic interests of the community. Defining the standards of modern management conduct in a large corporation is one of the major problems of the corporate field.

It is appropriate to add that in most of the other great industrial countries of the world, such standards were never defined, and the new responsibilities were

thought to have been disregarded by corporate managements. One result was a movement toward socialism which has left the United States alone among the great nations of the world to continue the pure capitalist system.

BAYER et al. v. BERAN et al.[27]

Supreme Court of New York, 1944. 49 N.Y.S.2d 2.

Derivative stockholders' suits by Seymour Bayer and another, suing on their own behalf as stockholders of Celanese Corporation of America and on behalf of all other stockholders of Celanese Corporation of America, similarly situated, against C. F. Beran.

Complaint dismissed.

SHIENTAG, JUSTICE. These derivative stockholders' suits present for review two transactions upon which plaintiffs seek to charge the individual defendants, who are directors, with liability in favor of the corporate defendant, the Celanese Corporation of America. There are two causes of action alleging breach of fiduciary duty by the directors, one in connection with a program of radio advertising embarked upon by the corporation towards the end of 1941, and the other relating to certain payments of $30,000 a year made to Henri Dreyfus, one of its vice-presidents and a director, pursuant to a contract of employment entered into with him by the corporation. Before taking up the specific transactions complained of, I shall consider generally certain pertinent rules to be applied in determining the liability of directors of a business corporation such as is here involved.

Despite abuses that have developed in connection with the derivative stockholders' suit, abuses which should be dealt with promptly and effectively, it must be remembered that such an action is, at present, the only civil remedy that stockholders have for breach of fiduciary duty on the part of those entrusted with the management and direction of their corporations. We cannot therefore allow the prevailing mood of justifiable dissatisfaction with some of the temporary incidents of such suits to cause us to lose sight of certain deep-rooted, traditional concepts of the obligations of directors to their corporation and its stockholders.

Directors of a business corporation are not trustees and are not held to strict accountability as such. Nevertheless, their obligations are analogous to those of trustees. Directors are agents; they are fiduciaries. The fiduciary has two paramount obligations: responsibility and loyalty. Those obligations apply with equal force to the humblest agent or broker and to the director of a great and powerful corporation. They lie at the very foundation of our whole system of free private enterprise and are as fresh and significant today as when they were formulated decades ago. The responsibility—that is, the care and the diligence—required of an agent or of a fiduciary, is proportioned to the occasion. It is a concept that has, and necessarily so, a wide penumbra of meaning—a concept, however, which becomes sharpened in its practical application to the given facts of a situation.

[27] Part of the opinion appears supra, p. 966.

The concept of loyalty, of constant, unqualified fidelity, has a definite and precise meaning. The fiduciary must subordinate his individual and private interests to his duty to the corporation whenever the two conflict. Winter v. Anderson, 242 App.Div. 430, 275 N.Y.S. 373. In an address delivered in 1934, Mr. Justice, now Chief Justice, Stone declared that the fiduciary principle of undivided loyalty was, in effect, "the precept as old as Holy Writ, that 'a man cannot serve two masters'. More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can long endure without loyalty to that principle". He went on to say that "The separation of ownership from management, the development of the corporate structure so as to vest in small groups control of resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function". Stone, The Public Influence of the Bar, 48 Harvard Law Review 1, 8.

A director is not an insurer. On the one hand, he is not called upon to use an extraordinary degree of care and prudence; and on the other hand it is established by the cases that it is not enough for a director to be honest, that fraud is not the orbit of his liability. The director may not act as a dummy or a figurehead. He is called upon to use care, to exercise judgment, the decree of care, the kind of judgment that one would give in similar situations to the conduct of his own affairs. Wangrow v. Wangrow, 211 App.Div. 552, 556, 207 N.Y. S. 132; 4 Fletcher Cyc. Corporations § 1035 et seq.; Hun v. Cary, 82 N.Y. 65, 37 Am.Rep. 546; Hanna v. Lyon, 179 N.Y. 107, 71 N.E. 778; Briggs v. Spaulding, 141 U.S. 132, 11 S.Ct. 924, 35 L.Ed. 662; General Rubber Co. v. Benedict, 164 App.Div. 332, 337, 149 N.Y.S. 880, 883, affirmed 215 N.Y. 18, 109 N.E. 96, L.R.A.1915F, 617.

The director of a business corporation is given a wide latitude of action. The law does not seek to deprive him of initiative and daring and vision. Business has its adventures, its bold adventures; and those who in good faith, and in the interests of the corporation they serve, embark upon them, are not to be penalized if failure, rather than success, results from their efforts. The law will not permit a course of conduct by directors, which would be applauded if it succeeded, to be condemned with a riot of adjectives simply because it failed. Directors of a commercial corporation may take chances, the same kind of chances that a man would take in his own business. Because they are given this wide latitude, the law will not hold directors liable for honest errors, for mistakes of judgment. The law will not interfere with the internal affairs of a corporation so long as it is managed by its directors pursuant to a free, honest exercise of judgment uninfluenced by personal, or by any considerations other than the welfare of the corporation.

To encourage freedom of action on the part of directors, or to put it another way, to discourage interference with the exercise of their free and independent judgment, there has grown up what is known as the "business judgment rule". Gamble v. Queens County Water

Co., 123 N.Y. 91, 99, 25 N.E. 201, 202, 9 L.R.A. 527; Weinberger v. Quinn, 264 App.Div. 405, 408, 35 N.Y.S.2d 567, 570; Everett v. Phillips, 288 N.Y. 227, 232, 43 N.E.2d 18, 19; Kalmanash v. Smith, 291 N.Y. 142, 155, 51 N.E.2d 681, 687. "Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient." Pollitz v. Wabash R. Co., 207 N.Y. 113, 124, 100 N.E. 721, 724. Indeed, although the concept of "responsibility" is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest.

The "business judgment rule", however, yields to the rule of undivided loyalty. This great rule of law is designed "to avoid the possibility of fraud and to avoid the temptation of self-interest." Conway, J., in Matter of Ryan's Will, 291 N.Y. 376, 406, 52 N.E.2d 909, 923. It is "designed to obliterate all divided loyalties which may creep into a fiduciary relation * * *." Thacher, J., in City Bank Farmers Trust Co. v. Cannon, 291 N.Y. 125, 132, 51 N.E.2d 674, 676. "Included within its scope is every situation in which a trustee chooses to deal with another in such close relation with the trustee that possible advantage to such other person might influence, consciously or unconsciously, the judgment of the trustee * * *." Lehman, Ch. J., in Albright v. Jefferson County National Bank, 292 N.Y. 31, 39, 53 N.E.2d 753, 756. The dealings of a director with the corporation for which he is the fiduciary are therefore viewed "with jealousy by the courts." Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 121 N.E. 378, 380. Such personal transactions of directors with their corporations, such transactions as may tend to produce a conflict between self-interest and fiduciary obligation, are, when challenged, examined with the most scrupulous care, and if there is any evidence of improvidence or oppression, any indication of unfairness or undue advantage, the transactions will be voided. Sage v. Culver, 147 N.Y. 241, 247, 41 N.E. 513, 514. See also Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18; Gerdes v. Reynolds, 281 N.Y. 180, 22 N.E.2d 331. "Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation are challenged the burden is on the director not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein." Pepper v. Litton, 308 U.S. 295, 306, 60 S.Ct. 238, 245, 84 L.Ed 281.

While there is a high moral purpose implicit in this transcendent fiduciary principle of undivided loyalty, it has back of it a profound understanding of human nature and of its frailties. It actually accomplishes a practical, beneficent purpose. It tends to prevent a clouded conception of fidelity that blurs the vision. It preserves the free exercise of judgment uncontaminated by the dross of divided allegiance

or self-interest. It prevents the operation of an influence that may be indirect but that is all the more potent for that reason. The law has set its face firmly against undermining "the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions." Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546, 62 A.L.R. 1.

The first, or "advertising", cause of action charges the directors with negligence, waste and improvidence in embarking the corporation upon a radio advertising program beginning in 1942 and costing about $1,000,000 a year. It is further charged that they were negligent in selecting the type of program and in renewing the radio contract for 1943. More serious than these allegations is the charge that the directors were motivated by a noncorporate purpose in causing the radio program to be undertaken and in expending large sums of money therefor. It is claimed that this radio advertising was for the benefit of Miss Jean Tennyson, one of the singers on the program, who in private life is Mrs. Camille Dreyfus, the wife of the president of the company and one of its directors; that it was undertaken to "further, foster and subsidize her career"; to "furnish a vehicle" for her talents.

Eliminating for the moment the part played by Miss Tennyson in the radio advertising campaign, it is clear that the character of the advertising, the amount to be expended therefor, and the manner in which it should be used, are all matters of business judgment and rest peculiarly within the discretion of the board of directors. Under the authorities previously cited, it is not, generally speaking, the function of a court of equity to review these matters or even to consider them. Had the wife of the president of the company not been involved, the advertising cause of action could have been disposed of summarily. Her connection with the program, however, makes it necessary to go into the facts in some detail.

Before 1942 the company had not resorted to radio advertising. While it had never maintained a fixed advertising budget, the company had, through its advertising department, spent substantial sums of money for advertising purposes. In 1941, for example, the advertising expense was $683,000, as against net sales for that year of $62,277,000 and net profits (before taxes) of $13,972,000. The advertising was at all times directed towards the creation of a consumer preference which would compel or induce the various trade elements linking the corporation to the consumer to label the corporation's products so that the consumer would know he was buying the material he wanted. The company had always claimed that its products, which it had called or labeled "Celanese", were different from rayon, chemically and physically; that its products had qualities, special and unique, which made them superior to rayon. The company had never called or designated its products as rayon.

As far back as ten years ago, a radio program was considered, but it did not seem attractive. In 1937, the Federal Trade Commission promulgated a rule, the effect of which was to require all celanese products to be designated and labeled rayon. The name "Celanese" could no longer be used alone. The products had to be called or labeled "rayon" or "celanese rayon". This gave the directors much concern. As one of them expressed it, "When we were compelled to

put our product under the same umbrella with rayon rather than being left outside as a separate product, a thermo-plastic such as nylon is, we believed we were being treated in an unfair manner and that it was up to us, however, to do the best we could to circumvent the situation in which we found ourselves. * * * All manner of things were considered but there seemed only one thing we could do. We could either multiply our current advertising and our method of advertising in the same mediums we had been using, or we could go into radio".

The directors, in considering the matter informally, but not collectively as a board, decided towards the end of 1941 to resort to the radio and to have the company go on the air with a dignified program of fine music, the kind of program which they felt would be in keeping with what they believed to be the beauty and superior quality of their products. The radio program was not adopted on the spur of the moment or at the whim of the directors. They acted after studies reported to them, made by the advertising department, beginning in 1939. A radio consultant was employed to advise as to time and station. An advertising agency of national repute was engaged to take charge of the formulation and production of the program. It was decided to expend about $1,000,000 a year, but the commitments were to be subject to cancellation every thirteen weeks, so that the maximum obligation of the company would be not more than $250,000.

So far, there is nothing on which to base any claim of breach of fiduciary duty. Some care, diligence, and prudence were exercised by these directors before they committed the company to the radio program. It was for the directors to determine whether they would resort to radio advertising; it was for them to conclude how much to spend; it was for them to decide the kind of program they would use. It would be an unwarranted act of interference for any court to attempt to substitute its judgment on these points for that of the directors, honestly arrived at. The expenditure was not reckless or unconscionable. Indeed, it bore a fair relationship to the total amount of net sales and to the earnings of the company. The fact that the company had offers of more business than it could handle did not, in law, preclude advertising. Many corporations not now doing any business in their products because of emergency conditions advertise those products extensively in order to preserve the good will, the public interest, during the war period. The fact that the company's product may not now be identifiable did not bar advertising calculated to induce consumer demand for such identification. That a program of classical and semiclassical music was selected, rather than a variety program, or a news commentator program, furnishes no ground for legal complaint. True, variety programs have a wider popular appeal than do musicals, but it would be a very sad thing if the former were the only kind of radio programs to be used. Some of the largest industrial concerns in the country have recognized this and have maintained fine musical programs on the radio for many years.

Now we have to take up an unfortunate incident, one which cannot be viewed with the complacency displayed by some of the directors of the company. This is not a closely held family corporation. The

Doctors Dreyfus and their families own about 135,000 shares of common stock, the other directors about 10,000 shares out of a total outstanding issue of 1,376,500 shares. Some of these other directors were originally employed by Dr. Camille Dreyfus, the president of the company. His wife, to whom he has been married for about twelve years, is known professionally as Miss Jean Tennyson and is a singer of wide experience.

Dr. Dreyfus, as was natural, consulted his wife about the proposed radio program; he also asked the advertising agency, that had been retained, to confer with her about it. She suggested the names of the artists, all stars of the Metropolitan Opera Company, and the name of the conductor, prominent in his field. She also offered her own services as a paid artist. All of her suggestions as to personnel were adopted by the advertising agency. While the record shows Miss Tennyson to be a competent singer, there is nothing to indicate that she was indispensable or essential to the success of the program. She received $500 an evening. It would be far-fetched to suggest that the directors caused the company to incur large expenditures for radio advertising to enable the president's wife to make $24,000 in 1942 and $20,500 in 1943.

Of course it is not improper to appoint relatives of officers or directors to responsible positions in a company. But where a close relative of the chief executive officer of a corporation, and one of its dominant directors, takes a position closely associated with a new and expensive field of activity, the motives of the directors are likely to be questioned. The board would be placed in a position where selfish, personal interests might be in conflict with the duty it owed to the corporation. That being so, the entire transaction, if challenged in the courts, must be subjected to the most rigorous scrutiny to determine whether the action of the directors was intended or calculated "to subserve some outside purpose, regardless of the consequences to the company, and in a manner inconsistent with its interests." Gamble v. Queens County Water Co., 123 N.Y. 91, 99, 25 N.E. 201, 202, 9 L.R.A. 527; Pollitz v. Wabash R. Co., 207 N.Y. 113, 124, 100 N.E. 721, 723.

After such careful scrutiny I have concluded that, up to the present, there has been no breach of fiduciary duty on the part of the directors. The president undoubtedly knew that his wife might be one of the paid artists on the program. The other directors did not know this until they had approved the campaign of radio advertising and the general type of radio program. The evidence fails to show that the program was designed to foster or subsidize "the career of Miss Tennyson as an artist" or to "furnish a vehicle for her talents". That her participation in the program may have enhanced her prestige as a singer is no ground for subjecting the directors to liability, as long as the advertising served a legitimate and a useful corporate purpose and the company received the full benefit thereof.

The musical quality of "Celanese Hour" has not been challenged, nor does the record contain anything reflecting on Miss Tennyson's competence as an artist. There is nothing in the testimony to show that some other soprano would have enhanced the artistic quality of the program or its advertising appeal. There is no suggestion that

the present program is inefficient or that its cost is disproportionate to what a program of that character reasonably entails. Miss Tennyson's contract with the advertising agency retained by the directors was on a standard form, negotiated through her professional agent. Her compensation, as well as that of the other artists, was in conformity with that paid for comparable work. She received less than any of the other artists on the program. Although she appeared with greater regularity than any other singer, she received no undue prominence, no special build-up. Indeed, all of the artists were subordinated to the advertisement of the company and of its products. The company was featured. It appears also that the popularity of the program has increased since it was inaugurated.

It is clear, therefore, that the directors have not been guilty of any breach of fiduciary duty, in embarking upon the program of radio advertising and in renewing it. It is unfortunate that they have allowed themselves to be placed in a position where their motives concerning future decisions on radio advertising may be impugned. The free mind should be ever jealous of its freedom. "Power of control carries with it a trust or duty to exercise that power faithfully to promote the corporate interests, and the courts of this State will insist upon scrupulous performance of that duty." Lehman, Ch. J., in Everett v. Phillips, 288 N.Y. 227, 232, 43 N.E.2d 18, 19. Thus far, that duty has been performed and with noteworthy success. The corporation has not, up to the present time, been wronged by the radio advertising attacked in the complaints. * * *

POST v. BUCK'S STOVE & RANGE COMPANY et al.

Circuit Court of Appeals of the United States, Eighth Circuit, 1912. 200 F. 918.

Appeal from the Circuit Court of the United States for the Eastern District of Missouri; David P. Dyer, Judge.

Suit by C. W. Post against the Buck's Stove & Range Company and others. Judgment for defendants, and plaintiff appeals. Affirmed.

HOOK, CIRCUIT JUDGE. This is a suit by Charles W. Post, as a stockholder of the Buck's Stove & Range Company, to enforce for its benefit a cause of action against the American Federation of Labor its allied organizations, and their representatives, for treble damages under section 7 of the Sherman Anti-Trust Act (26 Stat. 209), resulting from a combination in restraint of trade and commerce. The bill of complaint was dismissed on demurrer, and Post appealed.

The Stove Company is a Missouri corporation, engaged in the manufacture and sale in interstate commerce of stoves and ranges. Its general offices and factory are at St. Louis, Mo. Its capital stock is $1,500,000, of which Post owns about 7 per cent. Some years ago a controversy arose in one of its manufacturing departments over the hours of labor, and the union employés quit. Thereupon the labor organizations throughout the United States inaugurated an extensive boycott against the company, its manufactured products, and those who persisted in dealing in them, thereby, according to the bill of complaint, unlawfully inflicting upon it a financial loss to the extent of

$250,000. The Stove Company brought a suit in the Supreme Court of the District of Columbia and obtained an injunction in broad terms. On appeal to the Court of Appeals of the District, the company again prevailed, though the injunction was substantially modified. 33 App. D.C. 83, 32 L.R.A.,N.S., 748. From the decree of that court the parties, both complainant and defendant, took appeals to the Supreme Court of the United States, but before the hearing they amicably adjusted their differences by executing writings containing expressions of mutual friendship and consideration, and provisions that the company would not sue because of past controversies, that it would establish union wages, hours of labor, and conditions of employment, and that the labor organizations on their part commended the product of the company to their members, sympathizers, and friends. When the settlement came to the attention of the Supreme Court, it dismissed the appeals as involving questions purely moot. 219 U.S. 581, 31 S.Ct. 472, 55 L.Ed. 345. A phase of the controversy appears in 221 U.S. 418, 31 S.Ct. 492, 55 L.Ed. 797, 34 L.R.A.,N.S., 874. Post protested against the settlement. In communications to the officers and directors of his company, he demanded that, having won its fight against the unlawful boycott, its right to recover the damages sustained be enforced. Failing in this, he brought the present suit as a stockholder, claiming the settlement was without consideration, and was illegal and void. The company was made a party defendant according to equity rule 94 then in force. The foregoing recital sufficiently presents the merits of the case, which we will consider to the exclusion of less important matters.

The settlement with the labor organizations was made upon the authority of the board of directors of the Stove Company, and the only objection or complaint by any one interested in or connected with it was by the minority stockholder. As the chartered agents of a corporation, the directors represent, not only the artificial body, but also all who own its shares of stock. While they must be mindful of the corporate welfare, and not act oppressively, fraudulently, or destructively of the corporate existence, or contrary to the laws of the state or nation, or the purposes for which the corporation was organized, nor dissipate its assets or secure private advantage at corporate expense, yet as its governing body they possess a wide discretion in determining its business policies and the methods of executing them, which a stockholder cannot control or have revised by an appeal to the courts. Hawes v. Oakland, 104 U.S. 450, 26 L.Ed. 827; Delaware & Hudson Co. v. Railroad, 213 U.S. 435, 29 S.Ct. 540, 53 L.Ed. 862. In United States v. Union Pacific R. Co., 98 U.S. 569, 611 (25 L.Ed. 143), the Supreme Court, speaking of a corporation, said:

"So long as it exists in the possession and unrestrained exercise of all its corporate powers, its board of directors, unless under judicial prohibition or compulsion, is vested with the sole authority to decide whether it will assert its right of action for a supposed injury, or will condone it."

In some respects there is an analogy between a corporation and a representative government, which proceeds according to the views of the majority within constitutional lines. The minority must rely upon

persuading the greater number of the right or expediency of their position, and, failing that, must yield, unless some recognized limitation has been broken.

It is averred in the bill of complaint that the Stove Company was injured to the extent of $250,000 by an illegal boycott of its interstate business, that the Sherman act gave it the right to threefold damages, and that the defendants who did the wrong were solvent and good for the amount. Upon this it is argued that the directors, against the protest of the complaining stockholder, paid $750,000 for immunity from unlawful attacks, and thereby gave away assets aggregating half the amount of its capital stock without consideration. The claim for a penalty or a punitive increase of actual damage like one for a forfeiture, is not a favorite in the law. In no true sense was the claim of that kind in the case at bar a property asset, and we do not doubt that the managing officers of the corporation could in their discretion waive or refuse to enforce it without being brought to account in a court of equity. The claim for actual damage to the business of the company was an asset in a way, but the fact that it was unacknowledged and unliquidated still remained. The averments in the bill do not change its essential character. It was not like money in bank, nor even a credit with the debtor's sense of obligation born of a quid pro quo. Barring adjustment, its liquidation and collection to any extent meant continued expensive litigation. In the most favorable view, that was the prospect before the directors, and they were entitled to look at it practically as is commonly done in business transactions. The courts favor settlements of controversies, both before and after litigation, and will rarely overhaul them with a critical eye.

It is also inaccurate to say there was a mere purchase of immunity from unlawful attacks upon the business of the company, or that its claim for damages was given up without consideration. When the litigation with the labor organization stopped, it stood upon the decree of injunction of the Court of Appeals of the District of Columbia. It is not our province to review that decree, but presumably it protected the company in all its legal rights. But, however this may be, there belonged to the labor organizations a large field of legitimate endeavor and activity, with respect to which every business man and corporation might lawfully contract with them, and regarding which negotiations and agreements are of everyday occurrence. Organized labor has become an important factor in modern industrial life, where its influence is widely recognized; and its rightful status in the law should not be denied because of excesses committed in its name. The directors of the Stove Company, charged with the management of its extensive interests, may have come to believe in the economic advantage of union wages, hours of labor, and conditions of employment, and may have regarded the affirmative friendship of the labor organizations as valuable and desirable, and their disfavor, not unlawfully exercised, as undesirable. In such a situation, and presumably it arose, there were sufficient elements of consideration for the contract, and to overthrow it we should not hunt for others, not expressed in the writings or acknowledged by either party. We see in the daily chronicles of business affairs frequent instances of similar negotiations and agree-

ments in which the managers of large enterprises participate, and what they do is accepted without question. The directors of the Stove Company did nothing more, save to yield an unliquidated claim for damages. It was their province to determine the wisdom or expediency of the course adopted. They did not act oppressively or fraudulently, and no stockholder gained or lost more or less than another. They acted in good faith, according to the lights given them, and for the welfare of all the interests in their charge. * * *

The decree is affirmed.

(a) Care

HUN v. CARY.

Court of Appeals of New York, 1880. 82 N.Y. 65, 37 Am.Rep. 546.

EARL, J. This action was brought by the receiver of the Central Savings Bank of the city of New York, against the defendants who were trustees of the bank, to recover damages which, it is alleged, they caused the bank by their misconduct as such trustees.

The first question to be considered is the measure of fidelity, care and diligence which such trustees owe to such a bank and its depositors. The relation existing between the corporation and its trustees is mainly that of principal and agent, and the relation between the trustees and the depositors is similar to that of trustee and cestui que trust. The trustees are bound to observe the limits placed upon their powers in the charter, and if they transcend such limits and cause damage they incur liability. If they act fraudulently or do a wilful wrong, it is not doubted that they may be held for all the damage they cause to the bank or its depositors. But if they act in good faith within the limits of powers conferred, using proper prudence and diligence, they are not responsible for mere mistakes or errors of judgment. That the trustees of such corporations are bound to use some diligence in the discharge of their duties cannot be disputed. All the authorities hold so. What degree of care and diligence are they bound to exercise? Not the highest degree, not such as a very vigilant or extremely careful person would exercise. If such were required, it would be difficult to find trustees who would incur the responsibility of such trust position. It would not be proper to answer the question by saying the lowest degree. Few persons would be willing to deposit money in savings banks, or to take stock in corporations, with the understanding that the trustees or directors were bound only to exercise slight care, such as inattentive persons would give to their own business, in the management of the large and important interests committed to their hands. When one deposits money in a savings bank, or takes stock in a corporation, thus divesting himself of the immediate control of his property, he expects, and has the right to expect, that the trustees or directors, who are chosen to take his place in the management and control of his property, will exercise ordinary care and prudence in the trusts committed to them—the same degree of care and prudence that men prompted by self-interest generally exercise in their own

affairs. When one voluntarily takes the position of trustee or director of a corporation, good faith, exact justice, and public policy unite in requiring of him such a degree of care and prudence, and it is a gross breach of duty—crassa negligentia—not to bestow them.

It is impossible to give the measure of culpable negligence for all cases, as the degree of care required depends upon the subjects to which it is to be applied. First Nat. Bank v. Ocean Nat. Bank, 60 N.Y. 278, 19 Am.Rep. 181. What would be slight neglect in the care of a quantity of iron might be gross neglect in the care of a jewel. What would be slight neglect in the care exercised in the affairs of a turnpike corporation or even of a manufacturing corporation, might be gross neglect in the care exercised in the management of a savings bank intrusted with the savings of a multitude of poor people, depending for its life upon credit and liable to be wrecked by the breath of suspicion. There is a classification of negligence to be found in the books, not always of practical value and yet sometimes serviceable, into slight negligence, gross negligence, and that decree of negligence intermediate the two attributed to the absence of ordinary care; and the claim on behalf of these trustees is that they can only be held responsible in this action in consequence of gross negligence, according to its ordinary meaning—as something nearly approaching fraud or bad faith—I cannot yield to this claim; and if there are any authorities upholding the claim, I emphatically dissent from them.

It seems to me that it would be a monstrous proposition to hold that trustees, intrusted with the management of the property, interests and business of other people, who divest themselves of the management and confide in them, are bound to give only slight care to the duties of their trust, and are liable only in case of gross inattention and negligence; and I have found no authority fully upholding such a proposition. It is true that authorities are found which hold that trustees are liable only for crassa negligentia, which literally means gross negligence; but that phrase has been defined to mean the absence of ordinary care and diligence adequate to the particular case. In Scott v. Depeyster, 1 Edw. Ch. 513, 543—a case much cited—the learned Vice Chancellor said: "I think the question in all such cases should and must necessarily be, whether they (directors) have omitted that care which men of common prudence take of their own concerns. To require more, would be adopting too rigid a rule rendering them liable for slight neglect; while to require less, would be relaxing too much the obligation which binds them to vigilance and attention in regard to the interests of those confided to their case, and expose them to liability for gross neglect only—which is very little short of fraud itself." In Spering's Appeal, 71 Pa. 11, 10 Am.Rep. 684, Judge Sharswood said: "They (directors) can only be regarded as mandataries—persons who have gratuitously undertaken to perform certain duties, and who are, therefore, bound to apply ordinary skill and diligence, but no more." In Hodges v. New England Screw Co., 1 R.I. 312, 53 Am.Dec. 624, Jenckes, J., said: "The sole question is whether the directors have or have not bestowed proper diligence. They are liable only for ordinary care; such care as prudent men take in their own affairs." And in the same case, Ames J., said: "They should not, therefore, be liable for innocent mistakes,

unintentional negligence, honest errors of judgment, but only for willful fraud or neglect, and want of ordinary knowledge and care." The same case came again under consideration in 3 R.I. 9, and Green, Ch. J., said: "We think a board of directors, acting in good faith and with reasonable care and diligence who nevertheless fall into a mistake, either as to law or fact, are not liable for the consequences of such mistake." In the case of The Liquidators of the Western Bank v. Douglas (11 Session Cases [3d Series], 112 [Scotch]), it is said: "Whatever the duties (of directors) are, they must be discharged with fidelity and conscience, and with ordinary and reasonable care. It is not necessary that I should attempt to define where excusable remissness ends and gross negligence begins. That must depend to a large extent on the circumstances. It is enough to say that gross negligence in the performance of such a duty, the want of reasonable and ordinary fidelity and care, will impose liability for loss thereby occasioned." In The Charitable Corporation v. Suton (2 Atkyns, 405) Lord Chancellor Hardwicke said, that a person who accepted the office of director of a corporation "is obliged to execute it with fidelity and reasonable diligence," although he acts without compensation. In Litchfield v. White, 5 N.Y. Super. Ct. 545, Sandford, J., said: "In general, a trustee is bound to manage and employ the trust property for the benefit of the cestui que trust with the care and diligence of a provident owner. Consequently he is liable for every loss sustained by reason of his negligence, want of caution, or mistake, as well as positive misconduct."

In Spering's Appeal, Judge Sharswood said that directors "are not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they were honest, and provided they are fairly within the scope of the powers and discretion confided to the managing body." As I understand this language, I cannot assent to it as properly defining to any extent the nature of a director's responsibility. Like a mandatary, to whom he has been likened, he is bound not only to exercise proper care and diligence, but ordinary skill and judgment. As he is bound to exercise ordinary skill and judgment, he cannot set up that he did not possess them. When damage is caused by his want of judgment, he cannot excuse himself by alleging his gross ignorance. One who voluntarily takes the position of director, and invites confidence in that relation, undertakes, like a mandatary, with those whom he represents or for whom he acts, that he possesses at least ordinary knowledge and skill, and that he will bring them to bear in the discharge of his duties. (Story on Bailments, § 182.) Such is the rule applicable to public officers, to professional men and to mechanics, and such is the rule which must be applicable to every person who undertakes to act for another in a situation or employment requiring skill and knowledge; and it matters not that the service is to be rendered gratuitously. These defendants voluntarily took the position of trustees of the bank. They invited depositors to confide to them their savings, and to intrust the safe-keeping and management of them to their skill and prudence. They undertook not only that they would discharge their duties with

proper care, but that they would exercise the ordinary skill and judgment requisite for the discharge of their delicate trust.

Enough has now been said to show what measure of diligence, skill and prudence the law exacts from managers and directors of corporations; and we are now prepared to examine the facts of this case, for the purpose of seeing if these trustees fell short of this measure in the matters alleged in the complaint.

This bank was incorporated by the act chapter 467 of the Laws of 1867, and it commenced business in the spring of that year, in a hired building, on the east side of Third avenue, in the city of New York. It remained there for several years, and then removed to the west side of the avenue, between Forty-fifth and Forty-sixth streets, where it occupied hired rooms until near the time of its failure in the fall of 1875. During the whole time the deposits averaged only about $70,000. In 1867, the income of the bank was $942.12, and the expenses, including amounts paid for safe, fixtures, charter, current expenses and interest to depositors, were $5,571.34. In 1868, the income was $5,471.43, and the expenses, including interest to depositors, $5,719.43. In 1869, the income was $3,918.27, and the expenses and interest paid $5,346.05. In 1870 the income was $5,784.09, and expenses and interest $7,040.22. In 1871 the income was $13,551.14, which included a bonus of $4,000, or $6,000 obtained upon the purchase of a mortgage of $40,000, which mortgage was again sold in 1874 at a discount of $2,000, and the expenses, including interest paid, were $9,124.05. In 1872 the income was $5,100.51, and the expenses, including interest paid, were $7,212.49. Down to the 1st day of January, 1873, therefore, the total expenses, including interest paid, were $5,046, more than the income. To this sum should be added $2,000, deducted on the sale of the large mortgage in 1874, which was purchased at the large discount in 1871, as above mentioned, and yet entered in the assets at its face. From this apparent deficiency should be deducted the value of the safe and furniture of the bank, from which the receiver subsequently realized $500. At the same date, the amount due to over one thousand depositors was about $70,000, and the assets of the bank consisted of about $13,000 in cash and the balance mostly of mortgages upon real estate.

While the bank was in this condition, with a lease of the rooms then occupied by it expiring May 1, 1874, the project of purchasing a lot and erecting a banking-house thereon began to be talked of among the trustees. The only reason put on record in the minutes of the meetings held by the trustees for procuring a new banking-house was to better the financial condition of the bank. In February, 1873, at a meeting of the trustees, a committee was appointed "on site for new building"; and in March the committee entered into contract for the purchase of a plot of land, consisting of four lots, on the corner of Forty-eighth street and Third avenue, for the sum of $74,500; of which $1,000 was to be paid down, $9,000 on the first day of May then next, and $64,000 to be secured by a mortgage, payable on or before May 1, 1875, with interest from May 1, 1873, at seven per cent.; and there was an agreement that payment of the principal sum secured by the mortgage might be extended to May 1, 1877, provided a building

should, without unavoidable delay, be erected upon the corner lot, worth not less than $25,000. This contract was reported by the committee to the trustees, at a meeting held April 7th. On the 1st day of May, 1873, the real estate was conveyed and the cash payment was made, and four separate mortgages were executed to secure the balance, one upon each lot. The mortgage upon the lot upon which the bank building was afterward erected was for $30,500. At the same time the bank became obligated to build upon that lot a building covering its whole front, 25 feet, and 60 feet deep, and not less than five stories high, and have the same enclosed by the first day of November then next. Upon that lot the bank proceeded, in the spring of 1875, to erect a building covering the whole front, and 76 feet deep, and five stories high, at an expense of about $27,000. And the building was nearly completed when the receiver of the bank was appointed, in November of that year. The three lots not needed for the building were disposed of, as we may assume, without any loss, leaving the corner lot used for the building to cost the bank $29,250. This case may then be treated as if these trustees had purchased the corner lot at $29,250, and bound themselves to erect thereon a building costing $27,000. When the receiver was appointed, that lot and building, and other assets which produced less than $1,000, constituted the whole property of the bank; and subsequently the lot and building were swept away by a mortgage foreclosure, and this action was brought to recover the damages caused to the bank by the alleged improper investment of its funds, as above stated, in the lot upon which the building was erected.

At the time of the purchase of the lot, the bank was substantially insolvent. If it had gone into liquidation, its assets would have fallen several thousand dollars short of discharging its liabilities, and this state of things was known to the trustees. It had been in existence about six years, doing a losing business. The amount of its deposits, which its managers had not been able to increase, shows that the enterprise was an abortion from the beginning, either because it lacked public confidence or was not needed in the place where it was located. It had changed its location once without any benefit. It had on hand but about $13,000 in cash, of which $10,000 were taken to make the first payments. The balance of its assets was mostly in mortgages not readily convertible. One was a mortgage for $40,000, which had been purchased at a large discount, and we may infer that it was not very saleable, as the trustees resolved to sell it as early as May, 1873, and in August, 1873, authorized it to be sold at a discount of not more than $2,500, and yet it was not sold until 1874. In this condition of things the trustees made the purchase complained of, under an obligation to place on the lot an expensive banking-house. Whether, under the circumstances, the purchase was such as the trustees, in the exercise of ordinary prudence, skill and care, could make; or whether the act of purchase was reckless, rash, extravagant, showing a want of ordinary prudence, skill and care, were questions for the jury. It is not disputed that, under the charter of this bank, as amended in 1868 (chap. 294), it had the power to purchase a lot for a banking-house "requisite for the transaction of its business." That was a power, like every other possessed by the bank, to be exercised with prudence and

and care. Situated as this moribund institution was, was it a prudent and reasonable thing to do, to invest nearly half of all the trust funds in this expensive lot, with an obligation to take most of the balance to erect thereon an extravagant building? The trustees were urged on by no real necessity. They had hired rooms where they could have remained; or if those rooms were not adequate for their small business, we may assume that others could have been hired. They put forward the claim upon the trial that the rooms they then occupied were not safe. That may have been a good reason for making them more secure, or for getting other rooms, but not for the extravagance in which they indulged. It is inferable, however, that the principal motive which influenced the trustees to make the change of location was to improve the financial condition of the bank by increasing its deposits. Their project was to buy this corner lot and erect thereon an imposing edifice, to inspire confidence, attract attention, and thus draw deposits. It was intended as a sort of advertisement of the bank, a very expensive one indeed. Savings banks are not organized as business enterprises. They have no stockholders, and are not to engage in speculations or money-making in a business sense. They are simply to take the deposits, usually small, which are offered, aggregate them, and keep and invest them safely, paying such interest to the depositors as is thus made, after deducting expenses, and paying the principal upon demand. It is not legitimate for the trustees of such a bank to seek deposits at the expense of present depositors. It is their business to take deposits when offered. It was not proper for these trustees—or at least the jury may have found that it was not—to take money then on deposit and invest it in a banking-house, merely for the purpose of drawing other deposits. In making this investment, the interests of the depositors, whose money was taken, can scarcely be said to have been consulted.

It matters not that the trustees purchased this lot for no more than a fair value, and that the loss was occasioned by the subsequent general decline in the value of real estate. They had no right to expose their bank to the hazard of such a decline. If the purchase was an improper one when made, it matters not that the loss came from the unavoidable fall in the value of the real estate purchased. The jury may have found that it was grossly careless for the trustees to lock up the funds in their charge in such an investment, where they could not be reached in any emergency which was likely to arise in the affairs of the crippled bank.

We conclude, therefore, that the evidence justified a finding by the jury that this was not a case of mere error or mistake of judgment on the part of the trustees, but that it was a case of improvidence, or reckless, unreasonable extravagance, in which the trustees failed in that measure of reasonable prudence, care and skill which the law requires. * * *

Judgment affirmed and appeal from order dismissed.

KAVANAUGH v. GOULD.

Court of Appeals of New York, 1918. 223 N.Y. 103, 119 N.E. 237.

CRANE, J. The defendant, a director of a trust company, has been sued to recover losses sustained by the company through his alleged neglect of duties. The courts below have decided in his favor. The sufficiency of the complaint was before us in 181 N.Y. 121, 73 N.E. 562, and 191 N.Y. 522, 84 N.E. 1115. Although a new trial must be had as the trial court failed to pass upon the issues presented by the pleadings, yet, in order to present the matter clearly, a statement of the principal facts involved is necessary.

The Trust Company of the Republic, now the Commonwealth Trust Company, was organized under the Banking Law of the state of New York in March of 1902 with a capital of $1,000,000 and a surplus of $500,000, fully paid. The respondent, George J. Gould, became a director and qualified April 3, 1902, when he filed his oath with the banking department. He resigned as such director October 29, 1902. Within that time the trust company suffered heavy losses from bad management. Gould never attended the meetings of the directors, nor acquainted himself with the business or methods of the trust company.

The law governing the duties of directors in financial institutions is well settled. They are summoned to the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs. Hun v. Cary, 82 N.Y. 65, 37 Am.Rep. 546; Cassidy v. Uhlmann, 170 N.Y. 505, 63 N.E. 554; Hanna v. Lyon, 179 N.Y. 107, 110, 71 N.E. 778; General Rubber Co. v. Benedict, 215 N.Y. 18, 109 N.E. 96, L.R.A.1915F, 617; Campbell v. Watson, 62 N.J.Eq. 396, 50 A. 120; Warner v. Penoyer, 91 F. 587, 33 C.C.A. 222, 44 L.R.A. 761. They should know of and give direction to the general affairs of the institution and its business policy, and have a general knowledge of the manner in which the business is conducted, the character of the investments, and the employment of the resources. No custom or practice can make a directorship a mere position of honor void of responsibility, or cause a name to become a substitute for care and attention. The personnel of a directorate may give confidence and attract custom; it must also afford protection. * * * By arrangement with Mr. Gould when he became a director, he was not expected to attend the meetings, or to take active part in the affairs of the company.

Upon the organization of the Trust Company of the Republic, Daniel Le Roy Dresser was elected president. He had been a very successful business man, stood well in the community, but was never a banker. He had never served as a director of a bank.

The by-laws adopted by the stockholders made provision for a board of directors of 25 and an executive committee consisting of the president and 6 other directors elected by the board. The executive committee had the powers of the board when the latter was not in session. For all investments in stocks, bonds, mortgages, and personal securities the assent of the executive committee was necessary. The presi-

dent, however, might be authorized by the executive committee to make investments in such securities without previously consulting it as to details, but all such transactions were to be reported at its next meeting. Tuesday of every week, at the main office of the company, was the meeting time for the executive committee. The directors were required to meet at the same place on the third Tuesday of every month. Regular minutes of the executive committee meetings were to be kept and read at the monthly meetings of the board. They were always to be open to any director. The president was also required to report the finances, affairs, and business of the company at the board meetings. Copies of the by-laws were given to each director; their sufficiency to properly regulate and control the affairs of the company was yet to be tested by experience. Dresser, the president, said:

"The by-laws were preliminary and experimental, and we were trying to feel our way and find out what was really best. They were permanent to the extent of being printed and distributed to the directors."

It was important, especially in a new company, that such by-laws as it did have should be complied with. When a by-law is adopted, it is as much the law of the corporation as if its provisions had been a part of the charter. Kent v. Quicksilver Mining Co., 78 N.Y. 159, 179; Hun v. Cary, 82 N.Y. 65, 37 Am.Rep. 546.

During the period in question, meetings of the board of directors were held on March 27th, April 15th, May 13th, June 17th, July 22d, September 16th, and October 21st. The meeting which should have been held on August 19, 1902, was passed. There was no meeting of the executive committee from the 22d day of July until the 9th of September.

Books were kept in which were recorded loans of various kinds and which were taken into the executive committee and board meetings, and were always open for inspection. The minutes of the executive committee, however, failed to show any loans reported to it or the nature of the securities taken for loans.

The losses sustained by the trust company were largely due to its connection with the United States Shipbuilding Company. It invested so heavily in the bonds of this company as to bring ruin to the institution but for the timely interference, in October of 1902—six months after its organization—of several of its directors. * * *

What a director must do in exercising reasonable care in the performance of his duties is always dependent upon the facts. Care is a relative term. This Trust Company of the Republic was of recent origin; its business had not become established or its methods fixed. Its president was a merchant with apparently no banking experience. Whether a director in exercising reasonable care would have left such an institution without some scrutiny of its initial investments or supervision of its loans, or without directing the nature of its business policy, is a question of fact for the trial court. * * *

Cf. Briggs v. Spaulding, 141 U.S. 132, 11 S.Ct. 924, 35 L.Ed. 662 (1890).

BARNES v. ANDREWS.

District Court of the United States, New York, 1924. 298 F. 614.

In Equity. Suit by Earl B. Barnes, as receiver of the Liberty Starters Corporation, against Charles Lee Andrews. Decree for defendant.

LEARNED HAND, DISTRICT JUDGE. * * * The first liability must rest upon the defendant's general inattention to his duties as a director. He cannot be charged with neglect in attending directors' meetings, because there were only two during his incumbency, and of these he was present at one and had an adequate excuse for his absence from the other. His liability must therefore depend upon his failure in general to keep advised of the conduct of the corporate affairs. The measure of a director's duties in this regard is uncertain; the courts contenting themselves with vague declaration, such as that a director must give reasonable attention to the corporate business. While directors are collectively the managers of the company, they are not expected to interfere individually in the actual conduct of its affairs. To do so would disturb the authority of the officers and destroy their individual responsibility, without which no proper discipline is possible. To them must be left the initiative and the immediate direction of the business; the directors can act individually only by counsel and advice to them. Yet they have an individual duty to keep themselves informed in some detail, and it is this duty which the defendant in my judgment failed adequately to perform.

All he did was to talk with Maynard as they met, while commuting from Flushing, or at their homes. That, indeed, might be enough, because Andrews had no reason to suspect Maynard's candor, nor has any reason to question it been yet disclosed. But it is plain that he did not press him for details, as he should. It is not enough to content oneself with general answers that the business looks promising and that all seems prosperous. Andrews was bound, certainly as the months wore on, to inform himself of what was going on with some particularity, and, if he had done so, he would have learned that there were delays in getting into production which were putting the enterprise in most serious peril. It is entirely clear from his letters of April 14, 1920, and June 21, 1920, that he had made no effort to keep advised of the actual conduct of the corporate affairs, but had allowed himself to be carried along as a figurehead, in complete reliance upon Maynard. In spite of his own substantial investment in the company, which I must assume was as dear to him as it would be to other men, his position required of him more than this. Having accepted a post of confidence, he was charged with an active duty to learn whether the company was moving to production, and why it was not, and to consider, as best he might, what could be done to avoid the conflicts among the personnel, or their incompetence, which was slowly bleeding it to death.

Therefore I cannot acquit Andrews of misprision in his office, though his integrity is unquestioned. The plaintiff must, however, go further than to show that he should have been more active in his duties. This cause of action rests upon a tort, as much though it be a

tort of omission as though it had rested upon a positive act. The plaintiff must accept the burden of showing that the performance of the defendant's duties would have avoided loss, and what loss it would have avoided. I pressed Mr. Alger to show me a case in which the courts have held that a director could be charged generally with the collapse of a business in respect of which he had been inattentive, and I am not aware that he has found one. In Bowerman v. Hammer, 250 U.S. 504, 39 S.Ct. 549, 63 L.Ed. 1113, the defendant was held for specific illegal loans, made by the president; so also in Kavanaugh v. Commonwealth Trust Co., 223 N.Y. 103, 119 N.E. 237. In Briggs v. Spaulding, 141 U.S. 132, 11 S.Ct. 924, 35 L.Ed. 662, a case decided by a narrow margin, which to-day would probably have gone the other way, the only attempt to charge the defendant was upon specific loans. Even in Hun v. Cary, 82 N.Y. 65, 37 Am.Rep. 546, it was for a single foolish investment that the defendant was held. The report of Allen v. Roydhouse (D.C.E.D.Pa.) 232 Fed. 1010, is not full enough to ascertain just what the verdict included, but apparently it, too, was for specific losses due to improper investments, and the same was true in Robinson v. Smith, 3 Paige (N.Y.) 222, 24 Am. Dec. 212.

When the corporate funds have been illegally lent, it is a fair inference that a protest would have stopped the loan, and that the director's neglect caused the loss. But when a business fails from general mismanagement, business incapacity, or bad judgment, how is it possible to say that a single director could have made the company successful, or how much in dollars he could have saved? Before this cause can go to a master, the plaintiff must show that, had Andrews done his full duty, he could have made the company prosper, or at least could have broken its fall. He must show what sum he could have saved the company. Neither of these has he made any effort to do.

The defendant is not subject to the burden of proving that the loss would have happened, whether he had done his duty or not. If he were, it would come to this: That, if a director were once shown slack in his duties, he would stand charged prima facie with the difference between the corporate treasury as it was, and as it would be, judged by a hypothetical standard of success. How could such a standard be determined? How could any one guess how far a director's skill and judgment would have prevailed upon his fellows, and what would have been the ultimate fate of the business, if they had? How is it possible to set any measure of liability, or to tell what he would have contributed to the event? Men's fortunes may not be subjected to such uncertain and speculative conjectures. It is hard to see how there can be any remedy, except one can put one's finger on a definite loss and say with reasonable assurance that protest would have deterred, or counsel persuaded, the managers who caused it. No men of sense would take the office, if the law imposed upon them a guaranty of the general success of their companies as a penalty for any negligence.

It is, indeed, hard to determine just what went wrong in the management of this company. Any conclusion is little better than a guess.

Still some discussion of the facts is necessary, and I shall discuss them. The claim that there were too many general employees turned out to be true, but, so far as I can see, only because of the delay in turning out the finished product. Had the factory gone into production in the spring of 1920, I cannot say, and the plaintiff cannot prove, that the selling department would have been prematurely or extravagantly organized. The expense of the stock sales was apparently not undue, and in any event Andrews was helpless to prevent it, because he found the contract an existing obligation of the company. So far as I can judge, the company had a fair chance of life, if the factory could have begun to turn out starters at the time expected. Whether this was the fault of Delano, as I suspect, is now too uncertain to say. It seems to me to make no difference in the result whether Delano, through inattention, or through sickness, or through contempt for Taylor, or for all these reasons, did not send along "Van Dycks," or whether Taylor should have got along without them, or should have shown more initiative and competence than he did. Between them the production lagged, until it was too late to resuscitate the dying company; its funds had oozed out in fixed payments, till there was nothing left with which to continue the business.

Suppose I charge Andrews with a complete knowledge of all that we have now learned. What action should he have taken, and how can I say that it would have stopped the losses? The plaintiff gives no definite answer to that question. Certainly he had no right to interject himself personally into the tangle; that was for Maynard to unravel. He would scarcely have helped to a solution by adding another cook to the broth. What suggestion could he have made to Maynard, or to his colleagues? The trouble arose either from an indifferent engineer, on whom the company was entirely dependent, or from an incompetent factory manager, who should have been discharged, or because the executives were themselves inefficient. Is Andrews to be charged for not insisting upon Taylor's discharge, or for not suggesting? Suppose he did suggest it; have I the slightest reason for saying that the directors would have discharged him? Or, had they discharged him, is it certain that a substitute employed in medias res would have speeded up production? Was there not as a fair chance that Delano and Taylor might be brought to an accommodation as there was in putting in a green man at that juncture? How can I, sitting here, lay it down that Andrews' intervention would have brought order out of this chaos, or how can I measure in dollars the losses he would have saved? Or am I to hold Andrews because he did not move to discharge Maynard? How can I know that a better man was available? It is easy to say that he should have done something, but that will not serve to harness upon him the whole loss, nor is it the equivalent of saying that, had he acted, the company would now flourish.

True, he was not very well-suited by experience for the job he had undertaken, but I cannot hold him on that account. After all, it is the same corporation that chose him which now seeks to charge him. I cannot agree with the language of Hun v. Cary, supra, that in effect he gave an implied warranty of any special fitness. Directors are not

specialists, like lawyers or doctors. They must have good sense, perhaps they must have acquaintance with affairs; but they need not—indeed, perhaps they should not—have any technical talent. They are the general advisers of the business, and if they faithfully give such ability as they have to their charge, it would not be lawful to hold them liable. Must a director guarantee that his judgment is good? Can shareholders call him to account for deficiencies which their votes assured him did not disqualify him for his office? While he may not have been the Cromwell for that Civil War, Andrews did not engage to play any such rôle.

I conclude, therefore, as to this first claim that there is no evidence that the defendant's neglect caused any losses to the company, and that, if there were, that loss cannot be ascertained. * * *

Bill dismissed, without costs.

BATES v. DRESSER.

DRESSER v. BATES.

BATES v. DEAN et al.

SAME v. BUNKER et al.

Supreme Court of the United States, 1920. 251 U.S. 524, 40 S.Ct. 247.

Appeals from the United States Circuit Court of Appeals for the First Circuit.

Suit by John L. Bates, receiver of the National City Bank of Cambrige, Mass., against Sumner Dresser, administrator of Edwin Dresser, deceased, and others. From a decree of the Circuit Court of Appeals (250 F. 525, 162 C.C.A. 541), reversing a decree of the District Court (229 F. 772), and dismissing the bill against some of the defendants, the receiver and certain defendants appeal. Modified and affirmed.

MR. JUSTICE HOLMES delivered the opinion of the Court.

This is a bill in equity brought by the receiver of a national bank to charge its former president and directors with the loss of a great part of its assets through the thefts of an employé of the bank while they were in power. The case was sent to a master who found for the defendant; but the District Court entered a decree against all of them. 229 F. 772. The Circuit Court of Appeals reversed this decree, dismissed the bill as against all except the administrator of Edwin Dresser, the president, cut down the amount with which he was charged [28] and refused to add interest from the date of the decree of the District Court. Dresser v. Bates, 250 F. 525, 162 C.C.A. 541. Dresser's administrator and the receiver both appeal, the latter contending that the decree of the District Court should be affirmed with interest and costs.

The bank was a little bank at Cambridge with a capital of $100,000 and average deposits of somewhere about $300,000. It had a cashier, a

[28] To $264,088.02.

bookkeeper, a teller and a messenger. Before and during the time of the losses. Dresser was its president and executive officer, a large stockholder, with an inactive deposit of from $35,000 to $50,000. From July, 1903, to the end, Frank L. Earl was cashier. Coleman, who made the trouble, entered the service of the bank as messenger in September, 1903. In January, 1904, he was promoted to be bookkeeper, being then not quite eighteen but having studied bookkeeping. In the previous August an auditor employed on the retirement of a cashier had reported that the daily balance book was very much behind, that it was impossible to prove the deposits, and that a competent bookkeeper should be employed upon the work immediately. Coleman kept the deposit ledger and this was the work that fell into his hands. There was no cage in the bank, and in 1904 and 1905 there were some small shortages in the accounts of three successive tellers that were not accounted for, and the last of them, Cutting, was asked by Dresser to resign on that ground. Before doing so he told Dresser that someone had taken the money and that if he might be allowed to stay he would set a trap and catch the man, but Dresser did not care to do that and thought that there was nothing wrong. From Cutting's resignation on October 7, 1905, Coleman acted as paying and receiving teller, in addition to his other duty, until November, 1907. During this time there were no shortages disclosed in the teller's accounts. In May, 1906, Coleman took $2,000 cash from the vaults of the bank, but restored it the next morning. In November of the same year he began the thefts that come into question here. Perhaps in the beginning he took the money directly. But as he ceased to have charge of the cash in November, 1907, he invented another way. Having a small account at the bank, he would draw checks for the amount he wanted, exchange checks with a Boston broker, get cash for the broker's check, and when his own check came to the bank through the clearing house, would abstract it from the envelope, enter the others on his book and conceal the difference by a charge to some other account or a false addition in the column of drafts or deposits in the depositors' ledger. He handed to the cashier only the slip from the clearing house that showed the totals. The cashier paid whatever appeared to be due and thus Coleman's checks were honored. So far as Coleman thought it necessary, in view of the absolute trust in him on the part of all concerned, he took care that his balances should agree with those in the cashier's book.

By May 1, 1907, Coleman had abstracted $17,000, concealing the fact by false additions in the column of total checks, and false balances in the deposit ledger. Then for the moment a safer concealment was effected by charging the whole to Dresser's account. Coleman adopted this method when a bank examiner was expected. Of course when the fraud was disguised by overcharging a depositor it could not be discovered except by calling in the passbooks, or taking all the deposit slips and comparing them with the depositors' ledger in detail. By November, 1907, the amount taken by Coleman was $30,100, and the charge on Dresser's account was $20,000. In 1908 the sum was raised from $33,000 to $49,671. In 1909 Coleman's activity began to increase. In January he took $6,829.26; in March, $10,833.73; in

June, his previous stealings amounting to $83,390.94, he took $5,152.-06; in July, $18,050; in August, $6,250; in September, $17,350; in October, $47,277.08; in November, $51,847; in December, $46,956.44; in January, 1910, $27,395.53; in February, $6,473.97; making a total of $310,143.02, when the bank closed on February 21, 1910. As a result of this the amount of the monthly deposits seemed to decline noticeably and the directors considered the matter in September, but concluded that the falling off was due in part to the springing up of rivals, whose deposits were increasing, but was parallel to a similar decrease in New York. An examination by a bank examiner in December, 1909, disclosed nothing wrong to him.

In this connection it should be mentioned that in the previous semi-annual examinations by national bank examiners nothing was discovered pointing to malfeasance. The cashier was honest and everybody believed that they could rely upon him, although in fact he relied too much upon Coleman, who also was unsuspected by all. If Earl had opened the envelopes from the clearing house, and had seen the checks, or had examined the deposit ledger with any care he would have found out what was going on. The scrutiny of anyone accustomed to such details would have discovered the false additions and other indicia of fraud that were on the face of the book. But it may be doubted whether anything less than a continuous pursuit of the figures through pages would have done so except by a lucky chance.

The question of the liability of the directors in this case is the question whether they neglected their duty by accepting the cashier's statement of liabilities and failing to inspect the depositors' ledger. The statements of assets always were correct. A by-law that had been allowed to become obsolete or nearly so is invoked as establishing their own standard of conduct. By that a committee was to be appointed every six months "to examine into the affairs of the bank, to count its cash, and compare its assets and liabilities with the balances on the general ledger, for the purpose of ascertaining whether or not the books are correctly kept, and the condition of the bank in a sound and solvent condition." Of course liabilities as well as assets must be known to know the condition and, as this case shows, peculations may be concealed as well by a false understatement of liabilities as by a false show of assets. But the former is not the direction in which fraud would have been looked for, especially on the part of one who at the time of his principal abstractions was not in contact with the funds. A debtor hardly expects to have his liability understated. Some animals must have given at least one exhibition of dangerous propensities before the owner can be held. This fraud was a novelty in the way of swindling a bank so far as the knowledge of any experience had reached Cambridge before 1910. We are not prepared to reverse the finding of the master and the Circuit Court of Appeals that the directors should not be held answerable for taking the cashier's statement of liabilities to be as correct as the statement of assets always was. If he had not been negligent without their knowledge it would have been. Their confidence seemed warranted by the semi-annual examinations by the Government examiner and they were encouraged in their belief that all was well by the president, whose

responsibility, as executive officer; interest, as large stockholder and depositor; and knowledge, from long daily presence in the bank, were greater than theirs. They were not bound by virtue of the office gratuitously assumed by them to call in the pass books and compare them with the ledger, and until the event showed the possibility they hardly could have seen that their failure to look at the ledger opened a way to fraud. See Briggs v. Spaulding, 141 U.S. 132, 11 S.Ct. 924, 35 L.Ed. 662; Warner v. Penoyer, 91 F. 587, 33 C.C.A. 222, 44, L.R.A. 761. We are not laying down general principles, however, but confine our decision to the circumstances of the particular case.

The position of the president is different. Practically he was the master of the situation. He was daily at the bank for hours, he had the deposit ledger in his hands at times and might have had it at any time. He had had hints and warnings in addition to those that we have mentioned, warnings that should not be magnified unduly, but still that taken with the auditor's report of 1903, the unexplained shortages, the suggestion of the teller, Cutting, in 1905, and the final seeming rapid decline in deposits, would have induced scrutiny but for an invincible repose upon the status quo. In 1908 one Fillmore learned that a package containing $150 left with the bank for safe keeping was not to be found, told Dresser of the loss, wrote to him that he could but conclude that the package had been destroyed or removed by someone connected with the bank, and in later conversation said that it was evident that there was a thief in the bank. He added that he would advise the president to look after Coleman, that he believed he was living at a pretty fast pace, and that he had pretty good authority for thinking that he was supporting a woman. In the same year or the year before, Coleman, whose pay was never more than twelve dollars a week, set up an automobile, as was known to Dresser and commented on unfavorably to him. There was also some evidence of notice to Dresser that Coleman was dealing in copper stocks. In 1909 came the great and inadequately explained seeming shrinkage in the deposits. No doubt plausible explanations of his conduct came from Coleman and the notice as to speculations may have been slight, but taking the whole story of the relations of the parties, we are not ready to say that the two courts below erred in finding that Dresser had been put upon his guard. However little the warnings may have pointed to the specific facts, had they been accepted they would have led to an examination of the depositors' ledger, a discovery of past and a prevention of future thefts. * * *

Decree modified by charging the estate of Dresser with interest from February 1, 1916, to June 1, 1918, upon the sum found to be due, and affirmed.

MR. JUSTICE MCKENNA and MR. JUSTICE PITNEY dissent, upon the ground that not only the administrator of the president of the bank but the other directors ought to be held liable to the extent to which they were held by the District Court. 229 F. 772.

MR. JUSTICE VAN DEVANTER and MR. JUSTICE BRANDEIS took no part in the decision.

(b) *Loyalty and Disinterestedness*

BOSWORTH v. ALLEN.

Court of Appeals of New York, 1901. 168 N.Y. 157, 61 N.E. 163.

Appeal from supreme court, appellate division, Fourth department.

Action by John H. Bosworth, receiver of the Genesee National Savings & Loan Association, against Charles M. Allen and others. From an order of the appellate division (67 N.Y.Supp. 1133) affirming an interlocutory judgment of the special term sustaining demurrer to the complaint, plaintiff appeals. Reversed.

The substance of the complaint is as follows: In 1898 the defendants were directors, duly elected by the stockholders, of the Genesee National Savings & Loan Association, a domestic corporation, the defendants Silas N. Gallup, James Walling, Ellery G. Allen, and Eli H. Gallup being respectively the president, vice president, secretary, and treasurer, and the defendant Charles M. Allen the attorney, for said corporation, appointed by the trustees pursuant to the by-laws. About the 11th of November, 1898, without the knowledge or consent of the stockholders, and in violation of their duty to the corporation, the defendants conspired with John L. White and John W. Reynolds, whom they knew to be irresponsible and untrustworthy, to elect them and other persons to be designated by them, whom they could control, as directors of the corporation, and to thereby place its business and property under their charge, and subject to sale and disposition by them. Pursuant to said conspiracy, the defendants agreed with Reynolds and White to resign in succession their positions as directors and officers, and elect in their places the said Reynolds and White, and other persons to be designated by them, for such purpose, and to thereby place in their possession and under their management and control the property, rights, and interests of the corporation, and to render the same subject to sale and disposition by the substituted management. In consideration of this agreement and these acts to be done by the defendants, said Reynolds and White and their associates were to pay to the defendants, upon the surrender of their capital stock to the corporation, the sum of $13,434.94, which exceeded its withdrawal value by $1,168.53. It was also part of the consideration that the corporation, by its board of directors, should hire the defendant Charles M. Allen as its counsel for the period of two years at a compensation of $200 a month, and that the defendant should be paid by Reynolds and White and the persons selected by them a bonus of about $18,000. In furtherance of such conspiracy, this agreement was carried into effect in all respects by the election of the new directors and officers, the placing of the business, property, and effects under their charge, and the making of a written contract with Charles M. Allen to employ him as counsel for the period and at the rate of compensation aforesaid. Such sums of money, to wit, $1,168.53 and about $18,000, were also paid in accordance with the agreement. All this is alleged to have been done on or about the 11th of November, 1898. It is further alleged that between the day last named and April 15, 1899, said White

and Reynolds and their associates, as trustees and officers, grossly mismanaged the business and property of the corporation, and wasted its assets by the payment of unnecessary and unearned salaries to themselves and others to the amount of $7,425.79, and by the payment of extravagant and unnecessary expenses in managing the business of the corporation to the amount of about $5,000. On or about the 11th of November, 1898, White, Reynolds, and their said associates, as trustees and officers of the corporation, made various wasteful and improvident contracts against the rights of the corporation and its stockholders, and without their knowledge or consent. The corporation was compelled to expend about $5,000 in annulling said contracts, recovering real estate conveyed pursuant thereto, obtaining possession of its assets and property, and ousting White, Reynolds, and their associates from their positions as officers and trustees. It was also deprived of rents, issues, and profits of said real estate and interest on money paid on said improvident contracts amounting to about $3,000. On the 15th of April, 1899, the corporation repudiated its contract with Charles M. Allen, and removed him from office as its counsel, but he claims that said contract is still binding, and that he is entitled, by virtue thereof, to receive the compensation stipulated thereby. The relief demanded is that the Allen contract be annulled; that the amount of money paid to the defendants, as alleged, be ascertained and determined, and that they be required to account for it; that the amount of damages sustained by the corporation by the wrongful acts of the defendants be fixed, and that it would have judgment therefor. There was also a prayer for general relief. * * *

VANN, J. (after stating the facts). The defendants conspired to wreck the corporation of which they were directors and to thereby make money for themselves. Although they sustained a relation of trust to the corporation and were bound to promote its interests and protect its property, they entered into a combination to destroy it in order to enrich themselves. While not technically trustees, for the title of the corporate property was in the corporation itself, they were charged with the duties and subject to the liabilities of trustees. Clothed with the power of controlling the property and managing the affairs of the corporation, without let or hindrance, as to third persons they were its agents, but as to the corporation, itself, equity holds them liable as trustees. * * * the directors of a corporation are charged with the duties of trustees and bound to care for its property and manage its affairs in good faith, and for a violation of that duty, resulting in waste of its assets, injury to its property, or unlawful gain to themselves, they are liable to account in equity the same as ordinary trustees. The corporation has the right to call upon them to account, not only for all the property intrusted to their care, but also for all moneys furtively made by them at its expense. * * *

The sum of $1,168.53, specifically alleged to have been paid to the defendants in excess of the withdrawal value of their shares, belonged to the corporation, and they are liable to account for it as money wrongfully paid to them pursuant to the conspiracy. The amount, not specifically alleged, paid to them for official action, was money ob-

tained pursuant to the same conspiracy by virtue of their office as directors, for which they must account as part of the assets of the corporation. This money they could not lawfully receive for themselves. They received it as the price of the transfer of all the corporate assets to the custody of irresponsible third parties, and the law, in order to protect the corporation, treats it as its property, and, therefore, money which it is entitled to recover from all the defendants. Their conspiracy was to keep it themselves, and the receipt thereof was an overt act in execution of the conspiracy. The loss of money by the corporation subsequent to the conspiracy, and in consequence thereof, through the wrongful acts of the defendants' successors, placed in office by their treachery, was the natural, and therefore the expected, result of the conspiracy itself. The value of the assets wasted and the amount of expense incurred as the direct and natural result of the conspiracy must be accounted for by the defendants, because those assets were intrusted to their care and protection as trustees, and, having broken their trust, they are liable for all the proximate consequences. * * * In a single equitable action the court may go to the bottom of the wrong, and work out, in such form as the facts require, all the relief called for by the conspiracy of the defendants against the corporation towards which they stood as trustees. The order appealed from should be reversed, the demurrers overruled, with costs in all courts, and the questions certified answered in the affirmative.

Ordered accordingly.

FORBES v. McDONALD et al.

Supreme Court of California, 1880. 54 Calif. 98.

Appeal from an order granting defendants a new trial, in the Fourth District Court, City and County of San Francisco. Morrison, J.

Department No. 2, MYRICK, J. Peter Owens was indebted to A. Forbes by reason of transactions in the stock of the Mahogany Gold and Silver Mining Company, in the sum of $2,102.50, for which Forbes held 150 shares of the stock as collateral, then worth about $4,200. Forbes was a trustee of the company. The management of the company was not harmonious, two trustees having views opposed to the other two, Forbes being the fifth. The defendants, McDonald and T. J. Owens, who were dealing in stock of the corporation, desired to have Forbes resign as trustee, that they might have some friend put in his place; and Forbes wanted payment of his indebtedness from Peter Owens secured. So, it was agreed that the defendants, McDonald and T. J. Owens, should give their promissory note for the amount of Peter Owens' indebtedness, payable at six months, interest at 1¼ per cent. per month, and Forbes should resign and aid them in electing a successor. The note was made payable to the plaintiffs, in which firm A. Forbes was a partner.

The note not having been paid, the plaintiffs brought suit; the defense of want of and illegality of consideration was interposed, and the case was heard by a jury. The Court below instructed the jury, in substance, among other things, that, if any part of the consideration

for the giving of the note was the resignation by Forbes of his office as trustee of the corporation, that the consideration was illegal, and the whole note was void, and plaintiffs could not recover. Notwithstanding this instruction, the jury rendered a verdict for the plaintiffs for the full amount of the note and interest. On motion of the defendants the Court below granted a new trial, and from this order this appeal is prosecuted.

It is not necessary to cite authorities to show that a contract is void if a portion only of the consideration is illegal. It does not appear to us to be at all doubtful, that if the whole or a part of a consideration be that a trustee resign his trust, the consideration is illegal. It is contra bonos mores. Trustees of corporations owe duties to others besides themselves; they have been placed in a position of trust by the stockholders, and to those stockholders they must be faithful. It is a violation of that trust for them to be bought out of office. They may resign when they please, but they must not make profit or benefit to themselves in the matter of such resignation.

The instructions of the Court below were correct; the verdict of the jury was contrary to the instructions, and the Court did not err in granting a new trial.

The order granting a new trial is affirmed.

PEOPLE ex rel. MANICE v. POWELL et al.

Court of Appeals of New York, 1911. 201 N.Y. 194, 94 N.E. 634.

Mandamus by the People, on the relation of William Manice, against William H. Powell and others to set aside proceedings by which relator was removed from the office of director of a domestic corporation, and for his reinstatement in such office. From an order of the Appellate Division (140 App.Div. 912, 125 N.Y.S. 1139), affirming as a matter of law, and not in discretion, an order of the Special Term denying a motion for a peremptory mandamus, relator appeals. Affirmed.

CHASE, J. The relator, who had been elected a director of the defendant Atlantic Terra Cotta Company for a term which will not expire until January, 1912, has been removed from his office as a director as hereinafter stated, and another person has been elected to fill the alleged vacancy, and he is now performing the duties as such director. The relator seeks by peremptory mandamus to set aside the proceedings by which it is alleged he was removed and to be reinstated in his office as a director. * * *

The learned justice at Special Term in denying the motion for a peremptory mandamus, referring to the relator, said: "As a director he was but an agent of the corporation, and the principles of the law of agency were applicable to him. If wrongfully removed before the expiration of the period for which he was elected, he is entitled to recover if damages have resulted; but he cannot insist upon being retained in a fiduciary relation towards the stockholders against the latter's wishes. The stockholders had the power to revoke the agency, though not the right." In the reason so given for the denial of the motion we think the distinction between a person occupying an ordi-

nary contract relation as an agent for a principal and a person elected for a specified term as a director of a private corporation was wholly overlooked. "The board of directors of a corporation do not stand in the same relation to the corporate body which a private agent holds towards his principal. * * * In corporate bodies the powers of the board of directors are in a very important sense original and undelegated." Hoyt v. Thompson's Executors, 19 N.Y. 207, 216; Beveridge v. N. Y. E. R. R. Co., 112 N.Y. 1, 22, 23, 19 N.E. 489, 2 L.R.A. 648.

While the ordinary rules of law relating to an agent are applicable in considering the acts of a board of directors in behalf of a corporation when dealing with third persons, the individual directors making up the board are not mere employés, but a part of an elected body of officers constituting the executive agents of the corporation. They hold such office charged with the duty to act for the corporation according to their best judgment, and in so doing they cannot be controlled in the reasonable exercise and performance of such duty. As a general rule, the stockholders cannot act in relation to the ordinary business of the corporation, nor can they control the directors in the exercise of the judgment vested in them by virtue of their office. The relation of the directors to the stockholders is essentially that of trustee and cestui que trust. The peculiar relation that they bear to the corporation and the owners of its stock grows out of the inability of the corporation to act except through such managing officers and agents. The corporation is the owner of the property, but the directors in the performance of their duty possess it, and act in every way as if they owned it.

This court in Bosworth v. Allen, 168 N.Y. 157, 61 N.E. 163, 55 L.R.A. 751, 85 Am.St.Rep. 667, referring to directors, say: "While not technically trustees, for the title of the corporate property was in the corporation itself, they were charged with the duties and subject to the liabilities of trustees. Clothed with the power of controlling the property and managing the affairs of the corporation, without let or hindrance, as to third persons they were its agents, but as to the corporation itself, equity holds them liable as trustees. 2 Pomeroy's Equity Jurisprudence, §§ 1061, 1063, 1088, 1097." The relator occupied a position toward the corporation that was one of trust and responsibility. He was given power and authority to act not only substantially uncontrolled by the corporation, but he was not subject to discharge as an employé unless such right is vested in some court or body of persons by statute or in its articles of incorporation duly authorized by statute. It would be somewhat startling to the business world if we definitely announced that the directors of a corporation were mere employés and that the stockholders of the corporation have the power to convene from time to time and remove at will any or all of the directors, although their respective terms of office have not expired. * * * [The court held that mandamus was not the appropriate remedy.]

Order affirmed.

GERDES et al. v. REYNOLDS et al.

BALLANTINE v. FERRETTI et al.

Supreme Court of New York, Special Term, 1941. 28 N.Y.S.2d 622.

Action by John Gerdes and another, trustees of the Reynolds Investment Company, Incorporated, debtor, against Clarence K. Reynolds, Franklin E. Mayer, and others to hold defendants accountable for assets of the company allegedly wasted and improperly applied, wherein defendants Mayer and another filed counterclaims and defendants Reynolds and another filed a cross-claim, and action by Arthur A. Ballantine, as trustee of the Continental Securities Corporation, against Vincent E. Ferretti and others, including Clarence K. Reynolds, Franklin E. Mayer, and others, to recover money allegedly taken from the treasury of the corporation illegally, wherein defendant Mayer filed a counterclaim and defendants Reynolds and another filed a cross-claim.

Counterclaims dismissed, and judgments in accordance with opinion. [Statement of facts from referee's report, 30 N.Y.S.2d 755, (Sup.Ct., N.Y., 1941):

PHILIP J. DUNN, REFEREE. * * * The defendants, Clarence K. Reynolds (hereinafter referred to as "Reynolds"), William F. Woodward, Richard S. Reynolds and Richard S. Reynolds, Jr. (the latter two of whom were not served in the action) owned the majority of the voting stock of Reynolds Investing Company, Inc., an investment trust, and constituted its board of directors. They sold their stock to a group composed in part of the defendants Prentice, Brady, Clayton, Ferretti and Calmur & Company, Inc.

Delivery of the major portion of the stock was made on December 31, 1937, the sellers receiving payment of approximately $1,500,000 of the purchase price of $2,110,000. At the same time, pursuant to the contract of sale, they resigned their offices as directors and elected as their successors the defendants Prentice, Mayer, Davis and McLanahan (who promptly elected Prentice president, Mayer vice-president, Davis secretary and Galvin, also a defendant herein, treasurer). The balance of the purchase price, in the sum of approximately $600,000 was paid on January 3 and January 12, 1938, and the balance of the stock delivered.

On January 3, 1938, the first business day after the new management had taken control, defendants Prentice and Davis, both directors and officers of the Company (acting under instruments executed by Mayer and Davis authorizing access to the safe deposit box of the company), proceeded, without any authorization of the board of directors, to open the box and remove therefrom securities worth approximately $1,000,000. These they placed in the possession of the brokerage firm of Prentice & Brady, of which defendants Prentice and Brady were members. During the next few days certain of these securities were sold by Prentice & Brady. Other securities of the company which had been pledged by the former management were redeemed and sold. As a result of these transactions, a credit balance of about $740,000, was

created in favor of Reynolds Investing Company on the books of Prentice & Brady, the remainder of the securities deposited or redeemed continuing in the possession of Prentice & Brady.

From these sources the management, on January 10th, to procure funds needed in their manipulation of this and other investment trusts of which they had gained control, now abstracted the sum of $882,500.

To accomplish this diversion of funds, and to give it the appearance of a legitimate transaction, a circuitous method was adopted. Prentice & Brady drew to the order of Reynolds Investing Company their check for $882,500, and charged the account of the company therewith. This check was never deposited or cashed by the company. Instead it was endorsed by the company, acting by the defendants Mayer as vice-president and Galvin as treasurer, to Continental Securities Corporation, which company, acting through officers thereof in league with the defendants Prentice, Ferretti and others, in turn endorsed it back to Prentice & Brady, who duly credited the account of Continental therewith.

The ostensible consideration for the transfer of this sum by Reynolds Investing Company to Continental was the sale at par by Continental to Reynolds Investing of 8,825 shares of stock of Fiscal Management Company, Limited, of a par value of $100 per share, physical possession of which shares had in fact been delivered to Reynolds Investing several days previously. In truth, these shares were wholly worthless, and were known by Prentice and his associates to be so.
* * *

As a result of the $882,500 check having been charged to its account, Reynolds Investing Company's credit balance on the books of Prentice & Brady, amounting to approximately $740,000, was wiped out, and a debit balance of about $140,000 created (which was shortly thereafter increased by the purchase of certain securities to about $240,000). As security for such debit balance Prentice & Brady still held securities belonging to Reynolds Investing Company of a value considerably in excess of that amount.

Several weeks later, by reason of a disagreement between the defendants Mayer and the other defendants who were in league with Prentice, the affairs of the company were placed in the hands of the law firm of Messrs. Chadbourne, Hunt, Jaeckel & Brown, who were retained on February 9, 1938. Not long after, the defendant Prentice resigned from the board of directors. The investigation of the Chadbourne firm disclosed the material facts of the conspiracy including the sale of the securities and the transaction involving the check of $882,500. The Chadbourne firm consulted with Mr. Irving Rossi, a well-known investment banker, and on March 18, 1938, a new board of directors of the Reynolds Company consisting of Mr. Rossi, James E. Bruch, who was vice-president of National Dairy Products Corporation, E. O. Sowerwine, who was assistant to the president of Anaconda Copper Company, W. A. Hanway who was Vice-president of Hydro Electric System, an affiliate of the International Pulp & Paper Company, were elected directors with Mr. Rossi as president.

This board, on March 24, 1938, obtained from Prentice & Brady the securities of the Reynolds Company still held by that firm, by author-

izing the payment to or for the account of Prentice & Brady of the sum of $233,846.77, the amount of the debit balance then standing against the company on the books of that firm.

On May 18, 1938, a petition for reorganization of the Reynolds Investing Company under the Corporate Reorganization Act, 11 U.S.C.A. § 207, was filed in the United States District Court in New Jersey. In the reorganization proceedings a plan contemplating the liquidation of the Reynolds Company was adopted and fees and expenses, including compensation to the trustee, accountants, attorneys for various committees, the attorneys for the petitioning creditors, etc., amounting to $182,722.24 were allowed and paid.

The interlocutory judgment herein has adjudged that the defendants Reynolds and Woodward shall pay the sum of $1,318,750 with interest, which sum was found by the court to represent the portion of the total purchase price of $2,110,000 received by the Reynolds group which was paid for the transfer of control and management of Reynolds Investing Company, as distinct from the transfer of its stock, such payment to be made in part to the plaintiffs and in part, for reasons not here material, to the trustee of Continental Securities Corporation. In addition, the judgment orders various defendants to account to the plaintiffs for property received, profits made, fees and commissions received and damages caused. * * *]

WALTER, JUSTICE. * * * Inherent in the very nature of stock corporations as constituted by our law are the settled principles that the shares of stock are the property of the stockholders, that the stockholders may sell their shares when and to whom they please and for such price as they can get, that they may sell to buyers of whose identity and integrity and responsibility they are unaware (as is the common practice in the multitudinous sales through brokers on and off exchanges), that the purchase price paid upon such sales belongs to the sellers, and that these same rights exist even where the stockholders hold a majority of the stock and where the sellers are a group who together own and sell such a majority. Equally inherent is the further principle that the holders of a majority (or other statutorially fixed percentage) of the voting shares elect the directors who are to manage the business affairs of the corporation, and in that sense and to that extent control the corporation and its assets. Equally inherent is the further principle that, in the absence of some statutory restriction, officers and directors may resign when they please; and in the case of this particular corporation, as in many others, the remaining directors were specifically authorized to fill vacancies. Over against these principles and rules there is the principle that officers and directors of a corporation, and under certain circumstances and for some purposes the majority stockholders, whether one or many, stand in a fiduciary relation to the corporation and to the minority stockholders, and must observe the high standards of diligence, good faith and loyalty required of all fiduciaries. These principles are not destructive one of the other. They are complementary to each other, and are merely misinterpreted when thought to be otherwise. The fact that a certain case states one without referring to the others thus affords no ground for supposing

that those not stated are rejected. (Compare Rodkinson v. Haecker, 248 N.Y. 480, 488, 489, 162 N.E. 493, where the ever-present necessity for considering principles in the light of the facts of particular cases is emphasized.)

The cases in which majority stockholders have been said to stand in a fiduciary relation to the minority have been cases in which the court was speaking of a matter of corporate management committed by statute directly to the stockholders rather than to the directors (Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 194, 195, 123 N.E. 148; Kroger v. Jaburg, 231 App.Div. 641, 248 N.Y.S. 387), or cases in which the majority have in fact assumed the management of the corporation's property or business (Southern Pacific Co. v. Bogert, 250 U.S. 483, 491, 39 S.Ct. 533, 63 L.Ed. 1099; Farmers' Loan & Trust Co. v. New York & Northern R. R. Co., 150 N.Y. 410, 430, 431, 44 N.E. 1043, 34 L.R.A. 76, 55 Am.St.Rep. 689; Cleary v. Higley, 154 Misc. 158, 168, 169, 277 N.Y.S. 63, affirmed 246 App.Div. 698, 284 N.Y.S. 989; Blaustein v. Pan American Petroleum & Transport Co., 174 Misc. 601, 665, 690, 21 N.Y.S.2d 651) or cases in which the majority have undertaken to act for the minority. Sautter v. Fulmer, 258 N.Y. 107, 179 N.E. 310; McManus v. Durant, 168 App.Div. 643, 154 N.Y.S. 580. Such cases may not exhaust the entire list of situations in which the majority may be held to be fiduciaries, but certainly as to matters not relating to management of the corporation's business or property, and in the absence of any express undertaking, the stockholders do not stand in a fiduciary relation to each other. Kavanaugh v. Kavanaugh Knitting Co., supra, 226 N.Y. at page 194, 123 N.E. 148; Rothchild v. Memphis & C. R. Co., 6 Cir., 113 F. 476, 479, 480, 481. Clearly, therefore, in the matter of selling their stock the holders of a majority thereof, whether one or a group, act for themselves alone and not as trustees, either technically or substantially, for the other stockholders, and no fiduciary duty is violated by such a sale, even though such sale ultimately bring about a change in the directorate. As long ago as 1896 the Court of Appeals, in speaking of a railroad corporation, said that "it is a matter of common knowledge that, where the ownership of a majority of the stock of such a corporation changes, the board usually changes, unless its members are already in harmony with the policy of the purchasers" (Farmers' Loan & Trust Co. v. New York & Northern R. Co., supra, 150 N.Y. at page 425, 44 N.E. at page 1046, 34 L.R.A. 76, 55 Am.St.Rep. 689), and that it is true today and is equally true of other kinds of corporations. No illegality can be found, therefore, in the mere fact of a sale of a majority of the voting stock with the necessarily accompanying incident of a change in the personality of those who by reason of stock ownership have the right to choose the directorate.

In this case, however, it indisputably was a condition of the sale that all the officers and directors then in office should forthwith resign and that under their power to fill vacancies they should forthwith elect an entirely new directorate chosen wholly by the purchaser of the stock, and all the officers and directors then in office did so resign and did so elect as directors persons designated by the purchaser. Furthermore, the brief submitted on behalf of this group of defendants accurately portrays the situation where it specifically states that the purchaser

"insisted that on the closing date sufficient stock to constitute a majority should be actually delivered or placed in escrow beyond the control of the sellers," and "made certain that the purchaser was bound to get delivery of enough shares to constitute a clear majority contemporaneously with the closing on December 31st," and the contract was so arranged as to insure the purchaser that "the majority block was irrevocably within his control the minute the deal closed on the 31st of December." Immediate and complete control in advance of payment of the entire purchase price was thus specifically bargained for and accorded. The officers and directors were made specifically aware of the fact that what the purchaser or purchasers wanted was immediate and actual control, and not merely the right to elect directors which incidentally follows from a sale of a majority of voting stock.

Officers and directors always and necessarily stand in a fiduciary relation to the corporation and to its stockholders and creditors. They undoubtedly may free themselves of that fiduciary relationship by ceasing to be officers and directors, but their right to resign, although sometimes stated with seeming absoluteness (Bruce v. Platt, 80 N.Y. 379, 383), is qualified by their fiduciary obligations to others. "Rights are never absolute and independent of those of others." O'Neill v. City of Port Jervis, 253 N.Y. 423, 430, 171 N.E. 694, 696. Officers and directors thus "cannot terminate their agency or accept the resignation of others if the immediate consequence would be to leave the interests of the company without proper care and protection." 1 Morawetz on Corporations, sec. 563, quoted in Zeltner v. Henry Zeltner Brewing Co., 174 N.Y. 247, 253, 66 N.E. 810, 812, 95 Am.St.Rep. 574; and see Carnaghan v. Exporters' & Producers' Oil Co., 57 Hun 588, 11 N.Y.S. 172, 175. Neither can they accept pay in any form or guise, direct or devious, for their own resignation or for the election of others in their place. [Citing cases.] * * *

The statement in 3 Cook on Corporations, 8th Ed., section 622a, that "a contract by which the directors who own a majority of the stock sell such stock and agree to substitute the vendees as directors of the company is legal," may be literally correct, but it must be read subject to many limitations, many of which are plainly stated in other sentences of the same section and in the accompanying footnotes and cited cases, and all which perhaps can be summed up by saying that such a contract cannot be made a vehicle for a violation of any fiduciary duty. As stated on the next page of the text, "All such transactions are closely scrutinized by the courts, and if fraudulent, as a matter of fact, the retiring directors are personally responsible for any losses." Needless to say, constructive fraud or breach of fiduciary duty would have the same result. Barnes v. Brown, 80 N.Y. 527, likewise merely recognizes what I already have stated as inherent in the nature of stock corporations, namely, that majority stockholders may dispose of their stock, and that when they do so such right of control as the law vests in the majority necessarily passes to the buyer as a legal incident of the sale. It gives no countenance to any idea that either the ownership of stock or the right to sell it carries with it any license to breach any sort of duty owed to anyone.

It is obvious, of course that it would be illegal for officers and directors to resign and elect as their successors persons who they knew intended to loot the corporation's treasury. Even stockholders, despite their right to sell their stock to whom they please, could not legally do that. Liability for such an act would not have to be predicated upon breach of a fiduciary relation, for the act would amount to a wilful and malicious injury to property, tortious in its very nature. See Phelan v. Edison Electric Illuminating Co., 24 Misc. 109, 112, 113, 53 N.Y.S. 305; Ingraham v. National Salt Co., 72 App.Div. 582, 584, 74 N.Y.S. 388, 76 N.Y.S. 1016; affimed 179 N.Y. 556, 71 N.E. 1131; Delavan v. New York, N. H. & H. R. R. Co., 154 App.Div 8, 13, 14, 130 N.Y.S. 17, in which denial of injunctions restraining transfers of majority stock was based upon the absence of facts indicating probable damage to the corporation by those to whom control was about to be transferred. I here find as a fact that none of the sellers of the stock of Reynolds Investing Company had any knowledge that the purchasers thereof, or any one acting for them, had any intention to loot the corporation or to pay any part of the purchase price out of the corporation's own assets. Whether or not the resigning officers and directors nevertheless are chargeable with notice of such an intention—whether or not it was, under all the circumstances, a risk reasonably to be perceived—is, of course, another question.

The questions determinative of the liability of corporate officers and directors in such a situation as is here disclosed thus appear to me to be these: (1) Are the circumstances such that, despite actual ignorance of unlawful plans and designs on the part of the purchasers, they are chargeable, with notice of such plans and designs, or, perhaps more accurately, with notice that unlawful plans and designs are a risk reasonably to be perceived? "The risk reasonably to be perceived defines the duty to be obeyed." Palsgraf v. Long Island R. R. Co., 248 N.Y. 339, 344, 162 N.E. 99, 100, 59 A.L.R. 1253. (2) Is the price paid in reality a price paid for the stock, or is it, in part at least, a price paid for the resignations of the existing officers and directors and the election of the buyer's nominees? And the principal factors which must supply the answers to these questions are the nature of the assets which are to pass into the possession and control of the purchasers by reason of the transaction, the method by which the transaction is to be consummated, and the relation of the price paid to the value of the stock.

The immediate consequence of the resignation of the entire body of officers and directors of a corporation obviously is at least potentially different where the corporation's assets are land and buildings and where they are securities which to all intents and purposes are practically negotiable, and such potential difference must be taken into account, both by the officers and directors and by a court judging their conduct, in considering whether their en masse resignations would leave the assets without proper care and protection, because the risk of dissipation or speedy misapplication obviously is greater. Such difference in the nature of the assets must be considered, also, in gauging the significance of the purchaser's conceded requirement that custody and possession of the assets be accorded before payment of a substantial part of the purchase price. An assumption that the officers

and directors of Reynolds Investing Company fully performed the fiduciary duty resting upon them thus requires an assumption that they realized that by doing what they did they were placing in the hands of those whom they elected as their successors the custody and possession of practically negotiable securities of a value of more than double the amount of the agreed purchase price, and were so placing such custody and possession at a time when a large part of the purchase price (over $600,000) still remained unpaid. For fiduciaries confronted with such a realization, I gravely doubt whether it is sufficient that they truthfully can say that they actually knew nothing against the character of the purchasers or of their nominees, or even that they had affirmative evidence that the purchasers were of good reputation. A man dealing with his own affairs may be as confiding and trusting as he pleases, and may be grossly negligent without being guilty of bad faith; but a fiduciary charged with the care of the property of others must be reasonably vigilant, and will not be heard to say that he did not know what the circumstances plainly indicated or that his faith in people was such that obvious opportunities for wrongdoing gave him no inkling that wrongdoing might be done, and schemes to acquire the stock of corporations by using assets of the corporation to pay the purchase price did not originate in the year 1937.

Precisely what would be the situation of directors who, by resignation and election, turned practically negotiable securities over to strangers who had not completed payment, need not be here determined, however, because here there is the added element that in connection with the same transaction a price was paid which is claimed to be grossly in excess of the value of the stock, and the situation of these directors must be considered in connection with that additional element.

Gross inadequacy of price long and frequently has been regarded as important evidence upon the question of good faith, and sometimes is sufficient in itself to charge a buyer with notice of fraudulent intent on the part of a seller. Anderson v. Nicholas, 28 N.Y. 600; First National Bank of Amsterdam v. Miller, 163 N.Y. 164, 57 N.E. 308; Second National Bank v. Weston, 172 N.Y. 250, 257, 64 N.E. 949; Johnson v. Woodworth, 134 App.Div. 715, 718, 119 N.Y.S. 146; Becker v. Hart, 135 App.Div. 785, 788, 789, 120 N.Y.S. 270; Moyer v. Bloomingdale, 38 App.Div. 227, 234, 56 N.Y.S. 991; 2 Pomeroy's Eq.Juris., 4th Ed., sec. 600, 747; Glenn, Fraudulent Conveyances, Rev.Ed., sec. 294, 298. For the same reasons, gross excessiveness of price may be equally significant in determining for what it really was paid, and may be sufficient to charge a seller with notice of a fraudulent intent on the part of a buyer.

Before discussing the question of excessiveness of price, however, I interject the finding of fact that the resigning officers and directors did not believe that Sartell Prentice was the purchaser of the 1,055,000 shares sold. They believed only that Prentice was interested as a purchaser in conjunction with other persons whose identity was unknown to them. * * *.

The substance of my holding, as I think already has been plainly indicated, is that the four officers and directors of Reynolds Investing Company arranged a transaction under which $791,250 was paid as the

purchase price for 1,555 shares of stock and $1,318,750 was paid as a price for their resignations and the election of another's nominees as their successors. The $791,250 cannot be recovered from any one because it was a lawful price paid for what the owners of the stock had a right to sell, and as the sale of the stock is not being either rescinded or treated as void it also follows that those who received the stock need not return it, unless, for reasons hereafter to be discussed, such return becomes necessary for a proper adjustment of equities. The $1,318,750 must be returned because it was an unlawful price paid for what no one had any right to sell and the proceeds of which, if sold, are treated, for remedial purposes, as the property of the corporation (Bosworth v. Allen, supra, 168 N.Y. at page 167, 61 N.E. 163, 55 L.R.A. 751, 85 Am.St.Rep. 667), and the persons who must return it are those who arranged the transaction and gave the illegal consideration for it, viz., the four officers who so resigned and elected the successors. The basis of their liability for its return is their participation in a breach of fiduciary duty, and their liability is joint and several (Jackson v. Smith, 254 U.S. 586, 589, 41 S.Ct. 200, 65 L.Ed. 418; Asphalt Construction Co. v. Bouker, 150 App.Div. 691, 694, 135 N.Y.S. 714, affirmed 210 N.Y. 643, 105 N.E. 1080; Irving Trust Co. v. Deutsch, 2 Cir., 73 F.2d 121, 125; Id., 2 Cir., 87 F.2d 1008), and as a part of that $1,318,750 is shown to have come from Continental, and as Continental's rights are not cut off by the intervention of any bona fide purchaser, equity should take the direct instead of the circuitous route and make them liable directly to Continental's trustee for that part. * * *

I conclude, therefore, that Continental's trustee is entitled to final judgment in his favor against defendants C. K. Reynolds and Woodward for $1,106,175.77, with interest thereon from December 31, 1937, and costs, or for $691,359.85, with like interest and costs, according to whether Continental's trustee elects to turn over or retain the 946,435 shares of common stock of Reynolds Investing Company. The judgment is not to run against C. K. Reynolds as trustee of any of the trusts mentioned in the pleadings and evidence. He is being held liable for acts done as an officer and director of Reynolds Investing Company. Whether or not he can seek contribution or indemnity from any other person is not susceptible of determination in this suit. * * *

The $1,666.66 paid to Prentice, and the $1,000 paid to Woodward, as alleged in the sixth and seventh causes of action in the Gerdes suit, will be included in the amounts to be accounted for by Prentice, and the $1,000 will be included in the amount to be accounted for by Woodward. Recovery of those sums is sought also from Mayer and McLanahan, but as I have found that they acted without guilty knowledge I do not think such recovery should be allowed.

Costs are awarded to the plaintiffs in both actions against all defendants against whom they prevail. No costs are awarded First Income Trading Corporation.

C. K. Reynolds and Woodward have pleaded cross-claims in which they allege that if a recovery be had against them it will have been brought about by reason of acts of others, and they consequently ask for judgment over against those others. No argument has been submitted in support of such cross-claims, and I seriously doubt whether

they can be sustained. Possibly, however, the facts to be developed upon the reference to be ordered in the Gerdes suit may show that their wrong has been aggravated by wrongs of others, and thus show a situation camparable to that of a wrongdoer whose wrong in causing a personal injury has been aggravated by malpractice of a physician, and for that reason the cross-claim in the Gerdes suit will be referred as to all defendants in that suit whom I have found to be actual wrong-doers. See Parchefsky v. Kroll Bros., Inc., 267 N.Y. 410, at page 414, 196 N.E. 308, 98 A.L.R. 1387. As to all other defendants in that suit such cross-claim is dismissed, but without costs. If C. K. Reynolds and Woodward desire a reference of their cross-claim in the Ballantine action in order to litigate it with additional defendants in that suit upon whom it has been served, such reference thereof may be included in the judgment to be entered in that suit.

Submit judgments accordingly.

(c) In Event of Conflicting Interest

(1) PERSONAL

ABBOT v. AMERICAN HARD RUBBER CO.

Supreme Court of New York, 1861. 33 Barb. 578.

[The statement of facts is omitted.]

ALLEN, J. The history of the origin, rise and progress of "The American Hard Rubber Company", and of the connection of the plaintiff with it, and of his dealings with and relations to the Goodyears and his other associates in the corporation, and the several patents referred to, is curious and instructive. The facts alleged are all important as bearing upon a question of fraud in fact involved in the case, and which will have to be met, unless the case upon a final hearing shall be disposed of upon the legal questions presented upon the undisputed facts. But upon this appeal, in the view I take of the legal rights of the parties, it will not be necessary to consider the question of actual fraud, and therefore I am relieved from the necessity of examining very critically the various and somewhat complicated and multifarious transactions stated with great detail in the complaint and answer. A very brief statement will suffice to present the questions which I deem essential to consider upon this appeal.

1. The "American Hard Rubber Company" of Connecticut, as distinguished from the "Beacon Dam Company," to which it succeeded, was originated and established to develop and bring into use the "hard rubber compound," to be manufactured under the patents of the Goodyears, in pursuance of the several arrangements and agreements with the patentees, and with a view to the pecuniary benefit of the corporators.

2. Between December, 1850, and February, 1860, mainly through the instrumentality of the plaintiff, the property and corporate franchises of the "Beacon Dam Company" were acquired; the name of the corporation changed, more clearly to indicate the new purpose and

object of the corporators; its capital increased from $25,000 to $300,-000; valuable and exclusive rights under the letters patent for making the hard compound of India rubber, including the right to make and vend, and sell to others the right to make and vend the compound, and to use it for the different purposes, and in the manufacture of the various articles for which it is valuable, were secured to the company; large additions were made to the real property and water privileges of the corporation, and extensive manufactories and shops for making the compound and bringing it into use in every variety of form, and for every variety of purpose, with machinery adapted to the design, were erected and put in operation.

3. The rights and franchises were acquired, the capital stock of the corporation increased, the additional real estate purchased, and the manufactories erected, and other expensive improvements made, solely for the purpose of making the interests and rights under the letters patent available and profitable to the associates, by manufacturing and using the compound under the patents. Except as connected with the manufacturing and bringing into use the hard compound of India rubber, the increased capital cannot be employed, and would not have been subscribed; the real property is, so far as the case shows, comparatively valueless to the company, and not essential to the carrying into execution the original purposes and objects of the "Beacon Dam Company"; and the buildings and machinery erected and constructed upon the property, adapted only to the manufacture of the hard rubber compound, and the making of the various articles to be made from it, are of necessity utterly valueless for other purposes, and are worth but little more than the materials of which they are composed.

In briefer terms, the increased capital, the additional real estate acquired, and the manufactories and machinery thereon, are valuable with the rights under the letters patent, but of comparatively little, if of any, value without such rights. Without the rights no prudent man would think of investing a dollar in the property and franchises, or looking after or caring for an investment already made, in the hope or expectation of getting any return from it.

4. At the time of the transaction complained of, the plaintiff was a stockholder in the company to the amount of $62,500, a creditor to the amount of $12,500, and under liabilities for the company to a large amount. He was also a trustee or director of the corporation, and had been from an early period in its history, if not from the commencement of the enterprise.

5. The direction of the company was, from June, 1855, committed to seven directors or trustees, of whom, in February, 1850, the plaintiff and the defendants Judson, Ropes, Norton and Henry B. Goodyear, were five, and by law it required four to constitute a quorum for the transaction of business. On the third day of February, 1860, the four defendants last named met as trustees at the office of Judson, in New York; but whether a meeting of the board of trustees had been adjourned to, or legally called, for that time and at that place, so as to give efficacy to their acts as a board, does not very satisfactorily appear from the allegations of the answer. The four trustees then resolved to sell to the firm of Poppenhusen & Konig, composed of the

defendants Poppenhusen, Konig and Funcke, all the personal property, tools, dies, machinery, fixtures, stock manufactured and unmanufactured, all the patent rights and privileges under the letters patent belonging to the corporation, together with the benefit of all contracts made with the corporation, for $120,000, to be settled for by the twelve notes of the purchasers of $10,000 each, payable one in each month for twelve successive months, and to lease the factory buildings and premises to the same parties for one year, at a rent of $3500.

6. On or after the ninth day of February, 1860, the resolution was carried into effect, and the sale consummated upon the terms mentioned.

7. The resolution was passed and the sale effected without the consent and against the wishes of the plaintiff, and against his protest and remonstrance. His objections were well known to his co-trustees, and there is reason to believe were also known to the purchasers before the consummation of the sale.

8. On the thirteenth day of February, 1860, the defendants Poppenhusen, Konig, Judson, Norton and Ropes associated themselves together, and became incorporated under the general laws of this state, under the name of "The American Hard Rubber Company," for the manufacture of articles, compounds, goods and substances, composed in whole or in part of India rubber, &c., &c.; that is, for the same purpose and under the same name as the Connecticut corporation named defendant in this action. The defendants last named were the five trustees named in the certificate of organization.

9. Poppenhusen & Konig immediately transferred to the new corporation all the property, rights and effects transferred to them a few days before by the old corporation.

Upon the undisputed facts of the case, thus fairly but imperfectly stated, the transactions complained of and the sale to Poppenhusen & Konig, cannot be permitted to stand. A bare statement of the case shows as conclusively as an elaborate argument could establish it, that the transfer was without power, and a violation of the trust and confidence reposed in the trustees and directors of the corporation. * * *

2. The transfer was a violation of trust and an abuse of the power vested in the directors to manage the affairs of the company, for the benefit of the corporators. As before suggested, I do not propose to consider the question of fraudulent intent or fraud in fact, involved in the case.

No principle is better settled than that a person having a duty to perform for others cannot act in the same matter for his own benefit. A trustee cannot, directly or indirectly, by himself or through the agency of another, become the purchaser of the trust estate. Neither can he purchase an interest in property, and hold it for his own benefit, when, in respect to such property, he has a duty to perform, inconsistent with the character of a purchaser on his own account. Van Epps v. Van Epps, 9 Paige, 237. Hawley v. Cramer, 4 Cow. 717. Slade v. Van Vechten, 11 Paige, 21. DeCaters v. LeRay De Chaumont, 3 Paige, 178. It requires no authority to establish the fact, that the

directors of the "American Hard Rubber Company" could not have transferred the property of the corporation directly to themselves, or to a corporation in which they were stockholders and directors. That is, they could not act as buyers and sellers in the same transaction, whether they acted in their individual capacity, or as the directors of two trading corporations. New York Central Ins. Co. v. National Protection Ins. Co., 20 Barb. 468. * * * This rule of law which makes certain cases of presumption conclusive, merely attaches itself to the circumstances when proved—it is not deduced from them. It is not a rule of inference from testimony, but a rule of protection as expedient for the public good. (Greenl.Ev. 32.) Here, the transfer to Poppenhusen and Konig, in Connecticut, was at the latest on the 9th of February, and on the 13th of the same month the new company was fully organized in New York, and the property and rights conveyed to Poppenhusen and Konig immediately transferred to it. The transfer from the original American Hard Rubber Company, of which the plaintiff was a stockholder, to the new company from which he is excluded, and in which three of the four trustees and directors making the conveyance, with Poppenhusen and Konig, are the sole corporators, was effected without any loss of time, as soon as it could well have been done, so that the transfer may be said to have been made by Poppenhusen and Konig to the new company, immediately on their receiving the title. There were only two entire days, exclusive of the Sunday intervening, for accomplishing the whole thing. It would be wrong to permit the presumption of intent attaching to these circumstances to be overcome by any amount of evidence. If it could be, stockholders would never be safe against the acts of faithless trustees. If evidence could prevail against the presumption, the affidavits of the parties implicated are entirely insufficient and unsatisfactory. But it is not necessary to comment upon them. The experiment of the acting trustees in the two hard rubber companies has the merit of boldness as well as originality. Three of them marched out of the old company, laden with spoils with which they enriched themselves as stockholders of the new, and it cannot be that their wronged and injured associates are remediless. The plaintiff is entitled to the relief demanded, and an injunction and receiver are necessary to the preservation of the property, and the protection of his interests, pendente lite.

The order of the court made at the special term should be affirmed, with costs.

SEYMOUR v. SPRING FOREST CEMETERY ASS'N.

Court of Appeals of New York, 1895. 144 N.Y. 333, 39 N.E. 365, 26 L.R.A. 859.

FINCH, J. This appeal is from a final judgment rendered upon an accounting which ascertained the amount payable upon bonds held by the plaintiff, and issued by the defendant corporation. Necessarily, the main questions involved are as to the legality of that issue, and the right of the plaintiff to hold and enforce the obligations upon which

she sues; and these questions arise out of a situation about which there is little, if any, dispute.

Eleven citizens of Binghamton became the owners of about 30 acres of land, which they bought for the purposes of a rural cemetery. Hotchkiss and Seymour, lawyers of standing and reputation in the city, owned an undivided tenth of the property; and each of the remaining nine associates, a similar share. They entered at once upon the work of improving the land, and preparing it for the intended use, and expended more or less of their own means upon it, looking forward to reimbursement and reasonable profit from the future sale of burial lots. As time passed, it became apparent that some change of the situation was imperatively needed. That every sale of a lot should require the signature of each of the eleven, and of their wives, was a serious inconvenience, and one likely to be greatly increased if any of the associates should die, leaving infant children to inherit. Good sense and sound business policy dictated that the tenancy in common of the individuals should be transformed into the single title of a corporation, and that change was effected. The associates conveyed to the newly-created corporation, of which they were the sole stockholders, and in which they were the only persons interested. They fixed the consideration of the transfer at $30,000, to be paid by the issue of corporate bonds to that amount, one-tenth of which was to be allotted to each of the original shares. Twenty-one thousand dollars in amount of such bonds was issued, and the securities delivered to the proper owners, and those bonds are still outstanding. While the technical form of this transaction was a sale by the 11 to the corporation, its substance was merely a change in the manner of holding. The sellers were the buyers. They sold as individuals, and bought as a corporation, and no one else had any interest in the question of price, or terms of sale. If they were the vendors, on the one hand, dealing with themselves, in a corporate capacity, on the other, they were also the sole beneficiaries to be affected, and could not defraud themselves. The abstraction of the corporate entity should never be allowed to bar out and pervert the real and obvious truth. As beneficiaries, the stockholders necessarily assented to all the details of the arrangement, and no just criticism is possible either upon the legality or morality of the transaction. Evidence was given to show that the land conveyed was not worth the sum secured, but that is a totally immaterial fact. Whatever the price, it wronged no one, and could wrong no one, and accomplished nothing, except to fix a primary limit to the anticipated profits. It was immaterial for another reason. The bonds were payable wholly out of the enterprise. First 50 per cent., and then 75 per cent., of the company's receipts from sales of lots, was to be applied on the bonds, and they were payable from no other source. If the price nominally fixed had been three times as great, its real product would have remained the same; for, either as bondholders or as stockholders, the whole proceeds, above expenses, would become theirs, and no more. It was the enterprise that was debtor, which could only pay by a liberal improvement and maintenance, and the actual price was the amount of its net surplus above expenditure, payable to the associates in the

capacity of bondholders, at least; a price to which they were fully entitled and which represented the profits they might justly claim to reap. No doctrine as to the dealing of a fiduciary agent with the property of his principal has any application to such a transfer as was made. * * *

But the further claim is made that because Hotchkiss and Seymour were officers of the corporation, holding a fiduciary relation, as trustees or directors, they could not lawfully buy the valid and outstanding obligations of the company at less than par, and enforce them for the full amount against the debtors. If that be sound doctrine, as is stoutly maintained,—if directors cannot, in any case, invest in the bonds of their own companies, except at the peril of a constructive fraud; if they cannot safely buy such bonds below par, because they deem them unduly depressed; if titles to corporate obligations, passing through their hands, become tainted by their touches,—it is quite time that the courts should give (what they have not given) a very definite and distinct warning. Some citations of seeming authority are pressed upon us, and others exist. The broad rule is stated in Perry, Trusts, § 428, that "a trustee, executor, or assignee cannot buy up a debt or incumbrance to which the trust estate is liable, for less than is actually due thereon, and make a profit to himself"; and that is the doctrine invoked in this case, as applicable to a director regarded as a trustee of the corporation. But the statement, however correct in its application to specific instances, must be taken with the limitations which belong to it. Its foundation is that a fiduciary agent, owing a duty to his principal, cannot make a contract for his own benefit which is or may be inconsistent with that duty; and the cases generally are of two kinds: The trustee buys in the property of his principal at a sacrifice, for his own benefit, when, if he bought it at all, it was his duty to do it for his principal; or he makes a contract, in behalf of his principal, with himself, directly or indirectly, as the other party to the agreement. The first class of cases is illustrated by Slade v. Van Vechten, 11 Paige, 26, where the assignee bought in assigned property at a sheriff's sale, and claimed the personal benefit of his bargain; and the second class, by Munson v. Railroad Co., 103 N.Y. 58, 8 N.E. 355, in which the directors contracting had a private and personal interest, possibly adverse to their fiduciary duty. Almost, if not quite, all of the cases cited by the learned counsel for the appellant belong to one or the other of these two classes. But they do not decide this case, for Hotchkiss and Seymour neither bought in any property of the company, nor dealt with the corporation in any respect. They made their contract, not with it, but with third persons, capable of protecting their own rights, and bought nothing which the corporation owned, or to which it had a right. We must go to still other cases, founded, it may be, to some extent, upon similar ideas of fiduciary duty, to discover even an approximate authority. There are cases of copartnership in which the general rules pertaining to that specific relation might prove to be broad enough to cover the purchase of the debt owing by the firm (Bank-Note Co. v. Edson, 56 Barb. 89), and other cases in which the duties flowing from a liquidation conducted by the trustee, and to

which he owes a specific trust duty, forbid a purchase by the trustee, for his own benefit, at a discount. But in every class of cases the rule is founded upon the unwillingness of the law to uphold contracts which bring into collision the trust duty and the personal interest; and it is because of that collision, and the temptations which surround it, that it declares the contract voidable at the election of the beneficiary, without investigating the good or bad faith of the trustee. The entire basis of the rule consists in this collision between trust duty and personal interest and the equitable prohibition has no application where there is no such possible inconsistency. There is no such conflict in the ordinary case of the purchase by a director in a going corporation of its outstanding obligations. There is no present duty resting upon him to extinguish them. The time for that has not come; the duty has not arisen, may never arise; the corporation is not prepared to pay, does not contemplate paying, but intends and expects to await the full maturity of the debt. Unless some special fund has been provided, or some special liquidation has been ordered, the director owes no duty to his company to discharge or buy in the outstanding bonds, and may purchase for himself, because no inconsistent trust duty has arisen. Why should he not? While the bonds are running to their maturity, and the corporation is not able to extinguish them, is not bound to do so, does not even wish or seek to do so, what does it matter who holds the securities, or on what terms they pass from hand to hand? It seems to me that we are asked to crowd the rule almost to the verge of an absurdity, and to inflict a vital injury upon business interests by tainting with invalidity the holding by a director of the unmatured obligations of the corporation bought by him in the open market, and not put in liquidation or sought to be extinguished. There must at least be some fact or circumstance which charges the trustee with a present duty to act for his company in respect to the bonds, which duty is or may be inconsistent with a personal purchase. No such duty rested upon Hotchkiss and Seymour, and they had a right to buy and hold for their own benefit. * * *

The judgment should be affirmed, with costs.

YOUNG v. COLUMBIA LAND & INVESTMENT CO.

Supreme Court of Oregon, 1909. 53 Or. 438, 99 P. 936, 133 Am.St.Rep. 844.

[The statement of facts is omitted.]

EAKIN, J. 1. The first question of importance is as to the right of plaintiffs, under the facts, to purchase the liabilities of defendant corporation at a discount for their own personal advantage. We conclude that their purchase of defendant's mortgage notes was made under such circumstances that the stockholders have a right to the advantage of it as made for the benefit of the company. An offer was made by W. C. Brown to sell to defendant company these mortgage notes at a discount and the change in the offer, making it a personal one to the plaintiffs, was made at the suggestion of one of the plaintiffs. The company was well able to take advantage of this offer, and the acting directors of defendant company were either par-

ties to the purchase or acquiescing in the transaction, notwithstanding it was their duty to use their best endeavor to advance the interest of the corporation. Where the trust duty of directors of a corporation and personal interest conflicts, the latter must give way. W. G. Gosline, in the interest of Hammond, and W. C. Smith, a stockholder, were active in attempting to procure some settlement of the notes and mortgage and in securing an offer of discount thereon for the benefit of the company. One witness testifies that there was some strife between the Hammond interest and that of the other stockholders, and in giving his reasons for desiring to get hold of the mortgage stated that some of the stockholders thought it about time to wind up the company, thus indicating that the purchase was made in opposition to the company's interest.

2. In Higgins v. Lansingh, 154 Ill. 301, 384, 40 N.E. 362, 387, it appears that Higgins owned such a large interest in the company that he practically controlled it. He also owned the secured debts of the company that were overdue, and purchased at a discount pledged stock of the company. It was held to be the duty of the managers of which he was one to make provision for their payment out of the resources of the company, if possible. He knew it was for the interest of the company to do so, but did not inform the other managers of the proposed sale, nor give the company any opportunity to receive the benefit of the transaction. The court said: "We have also held that a director may purchase outstanding obligations of the company and enforce their collection. But the question, so far as we know, has not before been presented whether or not he may purchase such claims at a discount, and enforce them in full. If he acts fairly and for the interest of the corporation, we think he may. He certainly would be doing the corporation no injury in case his management were in the interest of the corporation, and it were given a fair opportunity to itself become the purchaser, and could not or would not embrace such opportunity. We are of the opinion, however, from the evidence in this case, that Higgins could not under the circumstances attending the transaction purchase these securities, as he did, at a discount, and hold them against the company for payment in full, but that the company and its stockholders have the right to treat the purchase as made for their benefit." We think the principle here announced applied to the case before us, and that it was the duty of its board to take up these notes to protect the interests of the stockholders, and not in their own right against the interest of the company. This principle in no way conflicts with the case of Seymour v. S. F. C. Ass'n, 144 N.Y. 333, 39 N.E. 365, 26 L.R.A. 859, relied upon by plaintiffs. The transaction in the case related to unmatured obligations of the company that it did not desire to take up, and it was upon that circumstance that the case rested. It is said in the opinion there are "other cases in which the duties flowing from a liquidation conducted by the trustee, and to which he owes a specific trust duty, forbid a purchase by the trustee for his own benefit at a discount. But in every class of cases the rule is founded upon the unwillingness of the law to uphold contracts which bring into collision that trust duty and the personal interest." And, if plaintiffs obtained these notes at a discount,

still the purchase must be treated as for the benefit of the company, and they cannot enforce the mortgage for more than the amount paid for it.

It is also important to ascertain the amount paid for the mortgage for the purpose of determining the amount for which the company is chargeable. There is some conflict in the evidence upon this question. Plaintiffs contend that they paid $11,000 for the notes, while defendant contends that plaintiffs paid but $5,000. The sum paid by plaintiffs in the whole transaction was $27,500 in payment of the individual notes of plaintiffs, amounting to $16,002, and the notes of Wright, Smith, and Prael, each $7,000, and the two notes of the company $11,000, together with 50 shares of stock of defendant company, held by Brown, at the price of $500. Plaintiffs contend that the mortgage notes were taken at their full value and all the discount was on the three notes of Smith, Wright, and Prael upon the theory that the makers of these three notes were insolvent, and that their 300 shares of stock, in defendant company, held by Brown as collateral security for the payment of their notes, were worth only $10 per share, Brown having offered his 50 shares at that value. But Brown was anxious to close out his interest in the company and was making a sacrifice for that purpose. The evidence shows that plaintiffs put a much higher value on the stock than $10 a share. This appears from their testimony, as well as from the offer of the company to sell to Hammond, as shown by Plaintiffs' Exhibit D, namely, $16,000, for the water front, and he to pay the mortgage notes and surrender his 100 shares of stock, and the people to be benefited by proposed improvements to pay defendant company a bonus of $10,000, leaving 100 acres of the land, probably worth $5,000, to defendant company. This would make the water front cost Hammond $30,000 and leave clear to plaintiffs the $16,000 to be paid by Hammond, and the 100 acres at $5,000, with the $10,000 bonus, making $31,000 to be divided among 800 shares, a valuation of over $36 per share, or, without the bonus, worth $26 a share at the lowest estimate. Other witnesses placed the value of the property much higher.

It was conceded that Brown made no discount to plaintiffs on their individual notes. Therefore the mortgage notes and the Wright, Smith, and Prael notes were purchased for $11,000, while the stock of those three men was at these figures worth $7,800, and was turned over to plaintiffs without other expense or trouble, showing that, if the full value had been paid for the mortgage notes, plaintiffs received the notes and stock of Wright, Smith, and Prael without consideration. These figures, together with the fact that Brown, shortly before this time, had been offering the mortgage notes for $5,000, tends strongly to corroborate the testimony of defendant's witnesses, and fully justifies the conclusion that the purchase price of the mortgage notes was $5,000.

We find no error in the decree of the lower court, and it is affirmed.

FARWELL v. PYLE-NATIONAL ELECTRIC HEADLIGHT COMPANY.

Supreme Court of Illinois, 1919. 289 Ill. 157, 124 N.E. 449.

Bill by Granger Farwell against the Pyle-National Electric Headlight Company. Judgment for complainant was reversed by the Appellate Court (212 Ill.App. 450), and complainant brings certiorari. Affirmed.

DUNN, C. J. On a bill filed against the Pyle-National Electric Headlight company in the superior court of Cook county by Granger Farwell, in his own behalf and as trustee, the court rendered a decree for an accounting, from which the complainant, being dissatisfied with the basis fixed for taking the account, appealed to the Appellate Court for the First District. The defendant assigned cross-errors, which were sustained. The decree was reversed, and the cause was remanded, with directions to dismiss the bill. Upon the petition of the complainant a writ of certiorari was awarded to bring up the record for review.

The Pyle-National Electric Headlight Company was incorporated in 1897 under the laws of New Jersey to manufacture and deal in electric headlights, and on February 9, 1897, George C. Pyle and Frank H. Ewers, who were the owners of four patents for steam turbines and three patents for electric lamps, of which Pyle was the inventor, entered into a written contract whereby they granted to the company an exclusive license to manufacture and sell patented articles and devices for all purposes for which such patented articles or devices, or parts thereof, could be utilized under the patents so assigned, or any patents or improvements that might thereafter be made to accomplish the same or similar purposes. The consideration for this agreement was $500 cash, $4,500 to be paid February 1, 1898, the issue to the owners of the patents of all capital stock of the corporation, of the par value of $700,000, except 10 shares, and the agreement of the corporation to pay monthly a royalty of 5 per cent. of the gross receipts derived from sales made under the license, such royalty to be not less than $150 for each calendar month from January 1, 1898. The president of the corporation was Royal C. Vilas, and the secretary Perry Trumbull.

The record does not show to whom the 6,990 shares of the capital stock which the contract provided should be issued to Pyle and Ewers were transferred, but it appears that Vilas and members of his family have during the entire existence of the corporation owned a majority of the stock, though the number of shares so owned by them, or by any of them, is not disclosed. Neither does the evidence show the names of the stockholders outside the Vilas family, or the number of their shares, except in a few instances. In January, 1898, an extension of a year on the $4,500 payment was agreed on and evidenced in writing, the contract of February 9, 1897, being in all other respects confirmed. The company was then manufacturing and selling the headlights, and paid royalties until March 1, 1898, but soon afterward began a suit in the superior court of Cook county, charging that Pyle and Ewers had procured the agreement of February 9, 1897, by fraudulent representa-

tions or concealments. This suit was settled in October, 1898, the royalties due October 1, 1898, were paid, and a written agreement was entered into for the dismissal of the suit at the complainant's costs, for a further extension of the $4,500 payment to January 1, 1900, and for the extension of the time of payment of royalties accruing for the period from October 1, 1898, to the end of December, 1899, to January 1, 1900.

In the latter part of 1898 or beginning of 1899 Granger Farwell became a director of the Pyle-National Electric Headlight Company at the request of Royal C. Vilas, who gave Farwell 10 shares of stock to qualify him for that position. Farwell afterward purchased more stock and continued to be a director until January, 1912, except for the period from February 7 to May 2, 1900, during which time no directors' meeting was held. On June 5, 1899, he obtained from Pyle and Ewers an assignment of their contract of February 9, 1897, with the Pyle-National Electric Headlight Company as well as of the legal title to the patents mentioned in that contract, and an agreement for the assignment of two other patents when issued upon applications then on file in the Patent Office—one for a rotary engine governor and the other for an arc lamp—of which patents the Pyle-National Electric Headlight Company would become the exclusive licensee by virtue of the agreement of February 9, 1897. These patents were subsequently issued and duly assigned to Farwell. The consideration of these assignments was $14,473.10, which Farwell paid. At the time of the assignment the payment of $4,500, which had been extended to January 1, 1900, and the royalties accruing since October 1, 1898, the payment of which had been extended to the same date, were unpaid, and they were afterward paid to Farwell. The purchase of the patents and all the contracts was made by Farwell for the joint benefit of Vilas and himself. Vilas soon after sold to Perry Trumbull one-third of his one-half interest.

Vilas was president, Trumbull secretary, and Vilas, Trumbull, and Farwell, directors, of the corporation, and the three were a majority of the board of directors. They continued to be such majority until February, 1901, when the number of directors was increased to seven, but at the same time Vilas and Farwell were appointed an executive committee, to which the board of directors delegated all its powers. Vilas died in 1904, and was succeeded as president by his brother, William Vilas, who died in 1908. Carrie A. Vilas, the widow of Royal C. Vilas, was then president until her death, in 1910, when her son, Royal C. Vilas, Jr., became president. He continued to hold that office when this suit was brought. After the assignment of the patents and contract to Farwell, the $4,500 payment and the deferred royalties, which were accumulating at the rate of more than $3,000 a year, payment of which had been postponed to January 1, 1900, were paid to him, and the monthly payment of royalties under the contract continued to be made in increasing amounts until 1912; the total amount of royalties so paid exceeding $144,000. After the death of Vilas and Trumbull, the monthly payments were made, one-half to Farwell, one-third of one-half to Trumbull's executor, and two-thirds of one-half to Vilas' heirs.

On May 14, 1912, Farwell filed this bill for himself, the heirs of Vilas, and the executor of Trumbull's will, alleging that the company had manufactured and sold large quantities of the articles mentioned in the contract under the patents and by virtue of its license, and had built up a large, lucrative, and prosperous business, but that for large quantities of the articles so made and sold it had not paid the royalties provided in the agreement. The defendant filed an answer, which was afterward amended, admitting the execution of the agreements and assignments alleged in the bill, averring that it had for many years paid royalties on the basis of the total sales of the electric headlight equipments embodying the inventions covered by the patents, insisting that upon a proper construction of the agreement it was not liable to pay royalties on the basis claimed by the complainant, alleging that it had discontinued the use of all the inventions covered by the patents in the construction of its electric headlight equipments, and denying that any royalties were due under the terms of the contract. * * *

The directors of a corporation are intrusted with the management of its business and property for the benefit of all the stockholders, and occupy the position of trustees for the collective body of stockholders in respect to such business. They are subject to the general rule, which prevails in regard to trusts and trustees, that they cannot use the trust property, or their relation to it, for their own personal gain. It is their duty to administer the corporate affairs for the common benefit of all the stockholders, and exercise their best care, skill, and judgment in the management of the corporate business solely in the interest of the corporation. 3 Thompson on Corp. § 4009, et seq. They cannot have or acquire any personal or pecuniary interest in conflict with their duty as such trustees. Hooker v. Midland Steel Co., 215 Ill. 444, 74 N.E. 445, 106 Am.St.Rep. 170. The mere statement of the rule gains its approval. In Nowak v. National Car Coupler Co., 260 Ill. 260, 103 N.E. 222, the question of the disqualification of a director to purchase property of the corporation was considered, and, citing previous cases, it was said:

"The general rule to be derived from the decisions is that a director of a solvent corporation may trade with, borrow money from, or loan money to the corporation, or purchase its property, but in doing so he must act fairly, and be free from all fraud and oppression, and must impose no unfair or unreasonable terms. While a director is not disabled from purchasing the property of his corporation, the transaction will be subjected to the closest scrutiny by a court of equity, and if it was not conducted with the utmost fairness, to the end that the full value of the property should be obtained, the court will set it aside."

There is here no purchase of property from or by the corporation, or contract between the director and the corporation, which is sought to be set aside; but the rule in regard to the duty of directors, as trustees for the stockholders, reaches further than to transactions occurring directly between the directors and the corporation. In Gilman, Clinton & Springfield Railroad Co. v. Kelly, 77 Ill. 426, it was stated that the same rule applies to directors as to all persons acting in a fiduciary capacity, which requires the utmost fidelity to the interests of the cestui que trust; that it is a breach of duty for the directors to

place themselves in a position where their own individual interests would prevent them from acting for the best interests of those they represent; and that the rule embraces every relation in which there may by any possibility arise a conflict between the duty to the person with whom the trustee is dealing or on whose account he is acting and his own individual interest.

"The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity. * * * In this conflict of interest the law wisely interposes. It acts not on the possibility that, in some cases, the sense of that duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty." Michoud v. Girod, 4 How. 503, 11 L.Ed. 1076.

It is conceded that a director may loan money to the corporation or purchase its bonds. It has not been decided in this state that he may purchase the corporation's outstanding obligations at a discount and enforce them in full, though it was intimated in Higgins v. Lansingh, 154 Ill. 301, 40 N.E. 362, that he may, if he act fairly and for the interest of the corporation. The intimation carries with it the corollary that he may not make such purchase for speculation in his own interest, and enforce payment for the full amount against the corporation. If it is for the interest of the corporation to buy its bonds at a discount, and it is financially able to do so, a director will not be permitted to buy those bonds at a discount and enforce payment in full against the corporation. In Harts v. Brown, 77 Ill. 226, where it was held that the directors of a corporation may trade with, borrow from, or loan money to the corporation on the same terms and in like manner as other persons, may purchase the property and stock belonging to it in the same manner as though they were not directors, and may purchase its bonds and other indebtedness, it is still said that if the company had possessed money or property, or any assets that could have been converted into money, with which to redeem and discharge its debts, then the purchase of them would have been in bad faith.

The contract of the corporation with Pyle and Ewers was not a liquidated demand against the corporation. It was an executory contract, continuing during the life of the patents, calling, not for the payment of certain sums of money at stated times, but for the payment, monthly, of 5 per cent. of the gross receipts from sales made by virtue of the contract. The interest of Pyle and Ewers was necessarily adverse to that of the corporation, and, under the principles which have been referred to, a director of a corporation could not acquire that interest for himself, unless he could make it appear that his act was for the interest of the corporation. The conflict of the individual interest of Farwell with that of the corporation, which it was his duty as a director to protect, is illustrated by the fact that he is claiming in this suit that he is entitled to royalties on sales of whole electric headlight equipments, and also on all sales of repairs and replacement parts, while the corporation contends that the royalties are payable only on the separate lamps, turbines, and governors, and not on the

whole equipment, and not on repair and replacement parts. Royalties had been paid on the whole equipments, and not upon repair or replacement parts, and the court held that they should have been paid, not upon whole equipments, but upon the patented articles and devices, and upon repair or replacement parts. These are not the only differences of construction, but are merely illustrative. In becoming the owner of the contract with Pyle and Ewers, Farwell placed himself in a position where his individual interest was in conflict with his duty to the corporation of which he was a director. He had no right to buy the contract for his own profit, but the corporation was entitled to the benefit of his bargain. It was solvent, and there is nothing to indicate that it was unable to purchase the contract. Farwell has been repaid many times over. The directors were bound to give the corporation the benefit of the royalties, instead of taking it to themselves. * * *

This suit is against the corporation, and is brought by the unfaithful director, who comes into equity to obtain the benefit of a contract which it is apparently a violation of his trust to enforce for his own benefit. The stockholders are not parties to the suit, and are represented only by the corporation, and their rights can be protected only through the corporation. If a decree should be rendered against the corporation, it would have to be paid out of the funds of the corporation, and the payment would fall proportionately on each stockholder. The complainant seeks to enforce a claim to which the corporation, on settled equitable principles, has a clear defense. It is no answer to this defense that equities exist against certain of the stockholders. If such equities do exist, they cannot be enforced in a suit to which stockholders are not parties, and a court will not be astute to ascertain equities in the distribution of profits among directors jointly engaged in the breach of trust.

The judgment of the Appellate Court is affirmed.

Judgment affirmed.

NEW YORK TRUST COMPANY v. AMERICAN REALTY COMPANY et al.

Court of Appeals of New York, 1926. 244 N.Y. 209, 155 N.E. 102.

Appeal from Supreme Court, Appellate Division, First Department.

Action by the New York Trust Company as trustee under a deed of trust from George F. Underwood and wife against the American Realty Company and another. From an order of the Appellate Division (215 App. Div. 416, 213 N.Y.S. 569) reversing an order of the Special Term, granting plaintiff's motion for judgment and answering certified question (216 App. Div. 755, 214 N.Y.S. 891), plaintiff appeals on certified questions by permission. Order of Appellate Division affirmed, and certified questions answered.

LEHMAN, J. * * * The defendant American Realty Company purchased in November, 1920, from the plaintiff more than 55,000 acres of timberland. The consideration agreed upon for the sale of this land was the sum of $1,364,895, to be paid to the plaintiff as trustee under a deed of trust from George F. Underwood and Jennie A.,

his wife, dated July 28, 1920, and, in addition, the execution of a contract between the said George F. Underwood and the International Paper Company, which owned all the capital stock of the American Realty Company; $1,000,000 of the said purchase price was paid in ten notes of American Realty Company, guaranteed by International Paper Company, each in the principal amount of $100,000, and maturing serially one on December 1st of each year from 1921 to 1930, both inclusive. Three of the said notes have been paid. The remaining seven are those referred to in the complaint herein.

George F. Underwood, named with his wife as the grantor of the deed of trust to the New York Trust Company, was a director of the International Paper Company from August 28, 1901, until his death on or about August 6, 1923, and was from October 24, 1906, until his death, a member of the executive committee of said company. He was also from September 25, 1918, until his death, the president and a director of the American Realty Company. The conveyance of the timberlands to the plaintiff under the deed of trust of July, 1920, from George F. Underwood and Jennie A. Underwood, his wife, was gratuitous. The land was to be sold as soon as possible. The trust deed directed that certain small amounts of the purchase price be paid over to designated charitable and other institutions, and that the great bulk be paid or applied either by outright gift or through the establishment of trust funds, to the benefit of the immediate family of George F. Underwood. The largest beneficiary under the said trust is his wife. * * *

Undoubtedly it has frequently been held that a director or officer of a corporation must account to the corporation for profits received in disregard of duty owed to the corporation. * * * The remedy has been granted at times even in cases where the corporation does not rescind the transaction through which such profits have been made by the delinquent trustee or agent. * * * An agent for a buyer must account to his principal for the amount allowed by the seller to the agent for his services in making the sale. McMillan v. Arthur, 98 N.Y. 167. On analogous principles an agent or director may be compelled to account for profits made on the sale of property to his principal, though the principal retains the property sold, where, even before such sale, the agent or director was holding the property as trustee for the principal. In such case, even though the corporation repudiates the act of the director as its agent upon the sale of the property at a profit, it would still be entitled to hold the property conveyed to it, because in equity, ownership by the agent was for the benefit of the corporation, and the fruits of such ownership belong to it. * * *

Different question arises where the agent sells to his principal at a profit property which the agent might have retained for himself or sold to a stranger. If the contract of purchase is rescinded, the principal has no title to the property or right to retain it. If the principal fails to return the property, he may not claim that the contract was made without authority. A corporation may not repudiate the obligations of a contract made with a director and at the same time retain its benefits. If the contract with the director was valid, the corporation must pay the agreed price; if invalid, the corporation must re-

scind or repudiate the contract in its entirety. A director who may sell or retain the property at his will may also determine the price which will induce him to sell to the corporation. Profit made is the fruit of his ownership, and not of his agency. Burland v. Earle, 1902 A.C. 83; Matter of Lady Forest [Murchison] Gold Mine, Ltd., 1901, 1 Ch. 582. The agent or director may, therefore, not be called upon to account for such profits. If the contract which fixed the amount of the seller's profits is not rescinded or void, the fact that the profits are so large that they might be called "exorbitant" is ordinarily immaterial. * * * For property which belonged wholly to Underwood, Underwood might lawfully exact from a purchaser any price he could obtain and retain any profits he could acquire. As to such property, legal wrong, if any, on the part of Underwood consisted only in his making a contract for the benefit of his family or himself with corporations to which he owed duty of undivided loyalty. So long as the defendants cling to the benefit of the contract so made and assert rights against the plaintiff which they derive only from such contract, they may not claim that their directors and agents acted wrongfully or caused them damage by imposing upon them corresponding contractual obligations.

Underwood had owned some of the land sold for some years. There is no claim that in buying these lands he acted as agent for the corporation, or that the corporation had any interest therein, legal or equitable. Part of the land he purchased in the year 1919. The defendants allege that he purchased this part, with knowledge that "International Paper Company contemplated and was considering the purchase of the tracts." If that knowledge induced the purchase by Underwood of land; if he acquired it with intent to divert into his own coffers prospective benefit which the corporation expected to acquire; if he bought for himself when duty to the corporation required him to act only for it—then the corporation might insist that his title so acquired was held for its benefit. Robinson v. Jewett, 116 N.Y. 40, 22 N.E. 224; Parker v. Nickerson, 112 Mass. 195. Here the allegations of the counterclaim may be construed as stating that Underwood bought with intention to resell to the corporation. That he might not do. Having so bought, he was under duty, on request of the corporation, to transfer the property to the corporation at cost. He could not rid himself of this trust by transferring the property to the plaintiff. The plaintiff took title subject to the same obligation. * * * To that extent the first counterclaim, therefore, states facts sufficient to constitute a cause of action.

The order of the Appellate Division should be affirmed with costs, and the certified questions answered in the affirmative.

UNION ICE COMPANY OF PHILADELPHIA v. HULTON et al.

Supreme Court of Pennsylvania, 1928. 291 Pa. 416, 140 A. 514.

Suit for an accounting by the Union Ice Company of Philadelphia against James Hulton, Sr., and others. Decree for plaintiff, and named defendant appeals. Affirmed.

SCHAFFER, J. Defendant appeals from the decree of the chancellor directing him to account. He was the president of plaintiff company, and made loans to it of $33,000. The loans not being paid, he brought suit against the company, and obtained judgment for the amount due to him, and issued execution and sold the property at sheriff's sale, purchasing it for a nominal sum, subject to a mortgage. He did not give the directors of the company any notice of the issuing of the execution or of the time and place of the sheriff's sale, and they did not know of either, although he had notified them of his intention to reduce his claim to judgment. Alleging that the fair market value of the property was much in excess of the amount at which he purchased it at the sale, this proceeding was begun to compel defendant to account, and the court by its decree requires him to do so.

Appellant takes the position that the chancellor erred in finding that he did not give the directors or stockholders notice of his intention to issue execution and to become the purchaser at the sheriff's sale. The basis of this contention is that the attorney, who represented him, and who was also vice president of the company told the directors that appellant would have to reduce his notes to judgment, and that eventually he would have to sell the property. This was not such notice as the directors were entitled to receive. It was vague and indefinite, only indicating a possible future intention. They were entitled to know when the execution issued, and the time and place of sale in order that they might take steps to protect the interests of the stockholders for whom they and defendant were trustees. Gilmore v. Gilmore Drug Co., 279 Pa. 193, 123 A. 730.

Appellant further contends that he was not required to give notice of the execution and sale; that, when he began legal proceedings to reduce his claim to judgment, that was notice of all the consequences that might result from such proceedings, including notice that the property of the company would be sold after judgment if it was not paid. While it is true that, in enforcing his claim against a corporation a director or officer may employ the same methods as are open to other creditors (14a Corpus Juris, § 1905), yet in so doing he must take no unfair advantage of it. He must be scrupulous to see that some one on the corporation's behalf knows what is being done so that its interests may be safeguarded. Hechelman v. Geyer, 248 Pa. 430, 94 A. 188, Ann.Cas.1917A, 236; Thompson on Corporations, § 1254, p. 245; Marr v. Marr, 73 N.J.Eq. 643, 70 A. 375, 133 Am.St.Rep. 742. The last citation being a case, closely analogous to the one at bar, where also the president of a corporation bought its property at a sale on his own judgment, and in which he gave no notice of the sale, and it was held that the complaining stockholder could either treat the defendant as his trustee to the extent that the defendant profited by the sale or set it aside. Law v. Fuller, 217 Pa. 439, 66 A. 754; cited by appellant in support of his contention that notice by him of the execution and sale was rot required, points out that, where an officer or director who is a creditor of the corporation enforces his claim against it, and buys its property in at the sale, he is "subject to severe scrutiny, and under the obligation of acting in the utmost good faith," and that, while he may buy at the sale, the sale must be a fair one. In the

pending case the proofs indicate that the price paid by appellant was not the fair value of the property. * * *

We are satisfied, in view of the fact that no notice was given of the execution or sale, and in the light of the prima facie proof that by his purchase appellant will profit at his company's expense, that the court properly decreed an accounting which will proceed in accordance with the equity rules.

The decree is affirmed, at appellant's cost.

ROSS TRANSPORT CO. v. CROTHERS.[29]

Court of Appeals of Maryland, 1946. 45 A.2d 267.

MARBURY, CHIEF JUSTICE. * * * It has long been the law in this State that trustees cannot purchase at their own sale, and trustees, in this sense, include directors of corporations. This principle of the law was discussed by Chief Justice LeGrand in the first of the cases involving the dealings of Sherman with the Cumberland Coal and Iron Company, Hoffman Coal Company v. Cumberland C. & I. Co., 16 Md. 456 at pages 507–508, 77 Am.Dec. 311. This case referred to the earlier case of Richardson v. Jones, 3 Gill & J. 163, 22 Am.Dec. 293. As authority for the general policy of the law forbidding a trustee to become a purchaser, either directly or indirectly at his own sale, and stating "if he does, such sale may, and will be set aside, on the proper and reasonable application of the parties interested." The same statement is repeated in the second Sherman case, Cumberland C. & I. Co. v. Sherman, 20 Md. 117, pages 133, 134. This would lead to the conclusion that such a transaction is entirely voidable at the option of a party interested. In the third case involving the same company, Cumberland Coal and Iron Co. v. Parish, 42 Md. 598, Judge Alvey, speaking for this Court said: "The affairs of corporations are generally intrusted to the exclusive management and control of the board of directors; and there is an inherent obligation, implied in the acceptance of such trust, not only that they will use their best efforts to promote the interest of the shareholders, but that they will in no manner use their positions to advance their own individual interest as distinguished from that of the corporation, or acquire interests that may conflict with the fair and proper discharge of their duty." After some other observations on the subject, the opinion then states: "The transaction may not be ipso facto void, but it is not necessary to establish that there has been actual fraud or imposition practiced by the party holding the confidential or fiduciary relation;—the onus of proof being upon him to establish the perfect fairness, adequacy, and equity of the transaction; and that too by proof entirely independent of the instrument under which he may claim." This last quotation indicates that such a transaction is not absolutely voided at the option of the interested parties, but shifts the burden of proof upon the directors to establish its fairness. This last view was again stated by Judge Alvey in the case of Booth v. Robinson, 55 Md. 419, at pages 441–442, and his words in the last case are quoted by this Court in the case of Penn. R.

[29] Statement of facts and first part of opinion appears, supra, p. 352.

Co. v. Minis, 120 Md. 461, at page 486, 87 A. 1062. See also Macgill v. Macgill, 135 Md. 384 and cases cited on page 394, 109 A. 72. Coffman v. Publishing Co., 167 Md. 275, 173 A. 248, and Williams v. Messick, 177 Md. 605, 11 A.2d 472, 129 A.L.R. 1035.

It is not necessary for us to determine in this case whether the sale of stock to the Williams family and Ross is voidable merely upon the application of some of the other stockholders, or whether proof of such sale merely makes it necessary for these appellants to show the complete equity of the transaction. If we take the latter view, which is that most favorable to these appellants, we must hold that the burden placed upon the two directors has not been met. They have not shown that the company needed the money so badly and was in such a financial condition that the sale of the additional stock to themselves was the only way the money could be obtained. On the contrary, the corporation appears to have been in a very good financial condition. It is probable that any necessary financing of any buses could easily have been arranged through some financial institution, and Williams and Ross benefited greatly by their action in selling the stock to themselves. Nor is there any corroboration of William's statement that it was all arranged in the beginning, who was to get this additional stock. None of the other incorporators or directors were called to testify about this, and Ross himself, as we have noted, did not testify at all. We conclude, therefore, that the sale must be set aside as a constructive fraud upon the other stockholders.

The decree will be affirmed.

Decree affirmed with costs.

(2) ARISING FROM "INTERLOCKING DIRECTORATE."

GLOBE WOOLEN COMPANY v. UTICA GAS & ELECTRIC COMPANY.

Court of Appeals of New York, 1918. 224 N.Y. 483, 121 N.E. 378.

Action by the Globe Woolen Company against the Utica Gas & Electric Company. From a judgment of the Appellate Division (170 App.Div. 940, 154 N.Y.S. 1123) modifying and affirming a judgment in favor of defendant, entered on the report of a referee, plaintiff appeals. Judgment affirmed.

CARDOZO, J. The plaintiff, a corporation, sues to compel the specific performance of contracts to supply electric current to its mills. The defendant, also a corporation, answers that the contracts were made under the dominating influence of a common director; that their terms are unfair, and their consequences oppressive; and that hence they may not stand. A referee has sustained the defense; and the Appellate Division, with some modification, has affirmed his judgment.

The plaintiff is the owner of two mills in the city of Utica. One is for the manufacture of worsteds, and the other for that of woolens. The defendant generates and sells electricity for light and power. For many years John F. Maynard has been the plaintiff's chief stockhold-

er, its president, and a member of its board of directors. He has also been a director of the defendant, and chairman of its executive committee. He received a single share of the defendant's stock to qualify him for office. He returned the share at once, and he has never held another. His property interest in the plaintiff is large. In the defendant he has none.

The history of the transaction may be briefly stated. At the beginning the mills were run by steam, and the plant was antiquated and inadequate. As early as 1903 one Greenidge, then the superintendent and later the general manager of the defendant's electrical department, suggested to Mr. Maynard the substitution of electric power. Nothing came of the suggestion then. Mr. Maynard was fearful that the cost of equipment would be too great unless the defendant would guarantee a saving in the cost of operation. None the less a change was felt to be important, and from time to time the subject was taken up anew. In 1904 there was an investigation of the power plant by Greenidge and a written report of its condition. For this service, though he was still in the defendant's employ, he was paid by Mr. Maynard. In 1905 the substitution of electricity was again considered, but dismissed as impracticable because of the plaintiff's continued insistence upon a guaranty of saving. In the fall of 1906 the project was renewed. It was renewed by Maynard and Greenidge, who debated it between themselves. There were other officers of the defendant who knew that the project was afoot, but they took no part in formulating it. Maynard still insisted upon a guaranty of saving. The plaintiff's books were thrown open to Greenidge, who calculated for himself the cost of operation with steam and the probable cost with electricity. When the investigation was over, a contract was closed. It took the form of letters exchanged between Greenidge and Maynard. In the letter signed by Greenidge, the defendant proposed to supply the plaintiff's worsted mill with electricity at a maximum rate of $.0104 per kilowatt hour, and to guarantee that the cost for heat and light and power would show a saving each month of $300 as compared with the cost for the corresponding month in the year previous to the change. There was to be a trial period ending July 1, 1907. Then, at the plaintiff's option, the contract was to run for five years, with a privilege of renewal for a like term. In a letter signed by Maynard on October 22, 1906, the plaintiff accepted the proposal. At once the defendant made preparations to install the new equipment. Six weeks, later, on December 1, 1906, Mr. Maynard laid the contract before the defendant's executive committee. He went to the meeting with Mr. Greenidge. The contract was read. Mr. Lewis, the vice president, asked Mr. Greenidge what the rate would be, and was told about $.0104 per kilowatt hour. Mr. Beardsley, another director, asked whether the contract was a profitable one for the company, and was told by Mr. Greenidge that it was. Mr. Maynard kept silent. A resolution was moved and carried that the contract be ratified. Mr. Maynard presided at the meeting, and put the resolution, but was excused from voting.

This settled the problem of power for the worsted mill. Attention was next directed to the woolen mill. Again Mr. Maynard and Mr. Greenidge put the project through unaided. In February, 1907, let-

ters, similar in most things to the earlier ones, were exchanged. The guaranty of saving for this mill as for the other was to be $300 a month. There were, however, new provisions to the effect that the contract should apply to "current used for any purposes in any extensions or additions to the mills," and that in case of shortage of electricity the plaintiff should be preferred in service over all other customers except the city of Utica. At a meeting of the executive committee held February 11, 1907, this contract was ratified. The statement was made by Mr. Greenidge, in the presence of Mr. Maynard, that it was practically a duplicate of the first contract, except that it related to another mill. Nothing was said about the new provisions. Mr. Maynard presided and put the resolution, but did not vote.

At a cost to the plaintiff of more than $21,000 the requisite changes in the mills were made, and the new power was supplied. It quickly appeared that the defendant had made a losing contract; but only gradually did the extent of the loss, its permanence, and its causes unfold themselves. Greenidge had miscalculated the amount of steam that would be required to heat the dye houses. The expenditure for coal mounted by leaps and bounds. The plaintiff dyed more yarn and less slubbing than before. But the dyeing of yarn takes twice as much heat as that of slubbing, and thus doubles the cost of fuel. These and like changes in the output of the mills had not been foreseen by Greenidge, and Maynard had not warned of them. In 1909 the defendant became alarmed at the mounting loss. Various tests and palliatives were suggested and adopted, but there was no change in the result. Finally, in February, 1911, the defendant gave notice of rescission. At that time it had supplied the plaintiff with electricity worth $69,500.75 if paid for at the maximum rate fixed by the contract, and $60,000 if paid for at the lowest rate charged to any customer in Utica. Yet not only had it received nothing, but it owed the plaintiff under its guaranty $11,721.41. The finding is that a like loss prolonged to the end of the term would amount to $300,000.

These are the contracts which the courts below have annulled. The referee annulled them absolutely. The Appellate Division imposed the condition that the defendant reimburse the plaintiff for the cost of installation. The defendant makes no complaint of the condition. The plaintiff, appealing, stands upon its bargain.

We think the evidence supports the conclusion that the contracts are voidable at the election of the defendant. The plaintiff does not deny that this would be true if the dual director had voted for their adoption. Munson v. Syracuse, G. & C. R. R. Co., 103 N.Y. 58, 8 N.E. 355. But the argument is that by refusing to vote he shifted the responsibility to his associates, and may reap a profit from their errors. One does not divest oneself so readily of one's duties as trustee. The refusal to vote has, indeed, this importance: It gives to the transaction the form and presumption of propriety, and requires one who would invalidate it to probe beneath the surface. Davids v. Davids, 135 App.Div. 206, 209, 120 N.Y.S. 350. But "the great rule of law" (Andrews, J., in Munson v. Syracuse, G. & C. R. R. Co., supra, 103 N. Y. at page 73, 8 N.E. at page 358) which holds a trustee to the duty of constant and unqualified fidelity is not a thing of forms and phrases. A

dominating influence may be exerted in other ways than by a vote. Adams v. Burke, 201 Ill. 395, 66 N.E. 235; Davids v. Davids, supra. A beneficiary, about to plunge into a ruinous course of dealing, may be betrayed by silence as well as by the spoken word.

The trustee is free to stand aloof, while others act, if all is equitable and fair. He cannot rid himself of the duty to warn and to denounce, if there is improvidence or oppression, either apparent on the surface, or lurking beneath the surface, but visible to his practiced eye. Davids v. Davids, supra; Crocker v. Cumberland Mining & Milling Co., 31 S. D. 137, 146, 139 N.W. 783; Fort Payne v. Hill, 174 Mass. 224, 54 N.E. 532; Wyman v. Bowman, 127 F. 257, 274, 62 C.C.A. 189.

There was an influence here, dominating, perhaps, and surely potent and persuasive, which was exerted by Mr. Maynard from the beginning to the end. In all the stages of preliminary treaty he dealt with a subordinate, who looked up to him as to a superior, and was alert to serve his pleasure. There was no clean-cut cleavage in those stages between his conflicting offices and agencies. Hoyle v. Plattsburgh & M. R. R. Co., 54 N.Y. 314, 328, 329, 13 Am.Rep. 595. No label identified the request of Mr. Maynard, the plaintiff's president, as something separate from the advice of Mr. Maynard, the defendant's chairman. Superior and subordinate together framed a contract, and together closed it. It came before the executive committee as an accomplished fact. The letters had been signed and delivered. Work had been begun. All that remained was a ratification, which may have been needless, and which, even if needful, took the aspect of mere formality. There was some attempt to show that Mr. Lewis, the vice president, had seen the letters before. The testimony of Mr. Greenidge indicates the contrary. In support of the judgment, we accept his testimony as true. That the letters had been seen by others, there is not even a pretense. The members of the committee, hearing the contract for the first time, knew that it had been framed by the chairman of the meeting. They were assured in his presence that it was just and equitable. Faith in his loyalty disarmed suspicion.

There was, then, a relation of trust reposed, of influence exerted, of superior knowledge on the one side and legitimate dependence on the other. Sage v. Culver, 147 N.Y. 241, 247, 41 N.E. 513; Davids v. Davids, supra. At least, a finding that there was this relation has evidence to sustain it. A trustee may not cling to contracts thus won, unless their terms are fair and just. Crocker v. Cumberland Mining & Milling Co., supra, and cases there cited; Dongan v. MacPherson, 1902 A.C. 197, 200; Thompson on Corp. 1228, 1231. His dealings with his beneficiary are "viewed with jealousy by the courts, and may be set aside on slight grounds." Twin Lick Oil Co. v. Marbury, 91 U. S. 587, 588 (23 L.Ed. 328). He takes the risk of an enforced surrender of his bargain if it turns out to be improvident. There must be candor and equity in the transaction, and some reasonable proportion between benefits and burdens.

The contracts before us do not survive these tests. The unfairness is startling, and the consequences have been disastrous. The mischief consists in this: That the guaranty has not been limited by a statement of the conditions under which the mills are to be run. No mat-

ter how large the business, no matter how great the increase in the price of labor or of fuel, no matter what the changes in the nature or the proportion of the products, no matter even though there be extensions of the plant, the defendant has pledged its word that for ten years there will be a saving of $600 a month, $300 for each mill, $7,200 a year. As a result of that pledge it has supplied the plaintiff with electric current for nothing, and owes, if the contract stands, about $11,000 for the privilege. These elements of unfairness Mr. Maynard must have known, if indeed his knowledge be material. He may not have known how great the loss would be. He may have trusted to the superior technical skill of Mr. Greenidge to compute with approximate accuracy the comparative cost of steam and electricity. But he cannot have failed to know that he held a one-sided contract which left the defendant at his mercy. He was not blind to the likelihood that in a term of ten years there would be changes in the business. The swiftness with which some of the changes followed permits the inference that they were premeditated. There was a prompt increase in the proportion of yarns as compared with slubbing when the guaranty of saving charged the defendant with the greater cost of fuel. But, whether these and other changes were premeditated or not, at least they were recognized as possible. With that recognition, no word of warning was uttered to Greenidge or to any of the defendant's officers. There slumbered within these contracts a potency of profit which the plaintiff neither ignored in their making nor forgot in their enforcement.

It is no answer to say that this potency, if obvious to Maynard, ought also to have been obvious to other members of the committee. They did not know, as he did, the likelihood or the significance of changes in the business. There was need, too, of reflection and analysis before the dangers stood revealed. For the man who framed the contracts, there was opportunity to consider and to judge. His fellow members, hearing them for the first time, and trustful of his loyalty, would have no thought of latent peril. That they had none is sufficiently attested by the fact that the contracts were approved. There was inequality, therefore, both in knowledge and in the opportunity for knowledge. It is not important in such circumstances whether the trustee foresaw the precise evils that developed. The inference that he did might not be unsupported by the evidence. But the indefinite possibilities of hardship, the opportunity in changing circumstances to wrest unlooked-for profits and impose unlooked-for losses, these must have been foreseen. Foreseen or not, they were there, and their presence permeates the contracts with oppression and inequity.

We hold, therefore, that the refusal to vote does not nullify as of course an influence and predominance exerted without a vote. We hold that the constant duty rests on a trustee to seek no harsh advantage to the detriment of his trust, but rather to protest and renounce if through the blindness of those who treat with him he gains what is unfair. And, because there is evidence that in the making of these contracts that duty was ignored, the power of equity was fittingly exercised to bring them to an end.

The judgment should be affirmed, with costs.

EVERETT v. PHILLIPS et al.

Court of Appeals of New York, 1942. 288 N.Y. 227, 43 N.E.2d 18.

Stockholders' derivative action by Victor S. Everett against Ellis L. Phillips and others, impleaded with others. From a judgment entered upon an order of the Appellate Division of the Supreme Court, 261 App.Div. 1082, 26 N.Y.S.2d 881, which reversed upon the law and the facts an interlocutory judgment in favor of plaintiff entered upon a decision of the court on trial at Special Term (Kadien, J.), 22 N.Y. S.2d 852, and directed a dismissal of the complaint on the law upon new findings, the plaintiff appeals.

Affirmed.

LEHMAN, CHIEF JUDGE. The plaintiff is the owner of 100 shares of the "participating stock" of Empire Power Corporation. The issued and outstanding capital stock of the corporation consists of 77,000 shares of six per cent cumulative preferred stock with a stated value of $7,133,000; 400,000 shares of "participating" stock with a stated value of $3,150,000, and 400,000 shares of common stock with a stated value of $1,000,000. The directors of the corporation and members of their families owned all the common stock and large amounts of the preferred stock and the "participating" stock. At the same time they also owned or controlled, directly or indirectly, 1,500,000 shares, constituting a majority of the common stock of Long Island Lighting Company. In 1931 and 1932 the Empire Power Corporation loaned to Long Island Lighting Company large sums of money. Payment of these loans was from time to time extended and the loans are still unpaid. Claiming that these loans and the extension of time of payment were ultra vires and were "not made to promote any business purpose of Empire Power Corporation, but were made for the sole purpose of promoting the interests of the individual defendants and that of Long Island Lighting Company," the plaintiff has brought an action in behalf of himself and other minority stockholders in which he has asked that directors of Empire Power Corporation named as individual defendants be compelled to demand payment of the indebtedness by Long Island Lighting Company and that "in the event that the said indebtedness cannot be collected from Long Island Lighting Company, then that the individual defendants shall be directed to pay the same." At Special Term an interlocutory judgment was granted awarding substantially the relief which the plaintiff asked. The judgment was unanimously reversed by the Appellate Division on the law and the facts and the complaint was dismissed.

To establish his cause of action the plaintiff must show that the individual defendants in causing the Empire Power Corporation to loan the moneys to the Long Island Lighting Company and in failing to demand payment of such loans as they became due, have acted in disregard of the duties they owe Empire Power Corporation and that Empire Power Corporation has suffered, or at least may suffer, some detriment or loss. In a long line of decisions this court has held directors who control corporate action responsible for dereliction of duty where they have used the property of the corporation or man-

aged its affairs to promote their own interests, disregarding the interests of the corporation. Power of control carries with it a trust or duty to exercise that power faithfully to promote the corporate interests, and the courts of this State will insist upon scrupulous performance of that duty. Yet, however high may be the standard of fidelity to duty which the court may exact, errors of judgment by directors do not alone suffice to demonstrate lack of fidelity. That is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs.

The plaintiff here is asserting a cause of action for wrong done to the corporation of which he is a minority stockholder. In such an action it is immaterial whether the minority stockholder who asserts it has a large or a small interest; but in determining whether those who have power to control the corporation have committed a wrong either to the corporation or to its stockholders, the corporate capital structure, the certificate of incorporation, and the corporate constitution or by-laws may be factors of great weight; for within limits prescribed by law these define to whom the power of control is entrusted, its scope and the manner in which it must be exercised. Directors are elected by the holders of stock which have voting rights. Here the certificate of incorporation of Empire Power Corporation provides that only the holders of common stock shall have voting rights. According to the testimony of the defendant Phillips, who has been president of the corporation from its formation in 1924 and who with George W. Olmsted, its vice-president until he died in 1940, owned or controlled, either directly or indirectly, all of its common stock, the corporation was "formed for the purpose of financing and taking care of the various companies in which we were then interested and later became interested further." They invited the public to subscribe to the capital of the corporation which would be managed by directors in whose election no other stockholders would have any part, and those who might furnish the capital which these directors would manage were not left under any illusion that the directors when acting for the corporation would be free from other interests which might prevent an unprejudiced exercise of judgment. The certificate of incorporation contained a provision that: "No contract or other transaction between the Corporation and any other corporation shall be affected or invalidated by the fact that any one or more of the directors of this Corporation is or are interested in, or is a director or officer, or are directors or officers of such other corporation, * * * and no contract, act or transaction of this Corporation with any person or persons, firm or corporation, shall be affected or invalidated by the fact that any director or directors of this Corporation is a party, or are parties to or interested in such contract, act or transaction, or in any way connected with such person or persons, firm or association, and each and every person who may become a director of this Corporation is hereby relieved from any liability that might otherwise exist from contracting with the Corporation for the benefit of himself or any firm, association or corporation in which he may be in anywise interested." It is against this background that the court must consider the claim of the appellant that he has established by the overwhelm-

ing weight of testimony that the directors were faithless to their trust.

The complaint of the plaintiff concerns, as we have said, loans made to Long Island Lighting Company. The defendants controlled that corporation. Their stock interest in it was large. According to the balance sheets of the corporation introduced in evidence by the plaintiff, the corporation in 1931 and also at the time of the trial had a very large surplus and was earning large profits, but needed money for the development of its business. Corporate balance sheets unfortunately do not always present a correct picture of the corporate finances. The Public Service Commission—on appropriate occasions—can and does make independent examinations of the balance sheets of utility corporations; a court can ordinarily consider only the evidence produced by the parties and no evidence was produced which would challenge the correctness of the balance sheets or which would enable the court to reconstruct them. We may not assume that the financial condition of the lighting company was not favorable, but the evidence establishes that unless it had succeeded in borrowing money it would have been obliged to discontinue payment of dividends, at least temporarily, and, to use all its earnings for needed improvements, and that perhaps the earnings might have provided insufficient moneys for its needs. The evidence establishes too that the defendants expected to derive benefit not only as stockholders but also in other ways from the moneys which, as directors, they caused Long Island Lighting Company to borrow. The question remains whether in seeking benefit for themselves and for the Long Island Lighting Company, which they controlled through stock ownership, they caused Empire Power Corporation, which the defendants also controlled through stock ownership, to make a loan, which might work harm to the Empire Power Corporation.

The Long Island Lighting Company at the end of 1930 owed banks approximately $10,500,000 on short term, unsecured notes. Though, according to the balance sheet of the Long Island Lighting Company, it had assets greatly in excess of its indebtedness, and had a net income of more than $3,000,000 a year, its financial position was not entirely safe or sound. The banks might press for payment of short term obligations at a time when Long Island Lighting Company might find it difficult to borrow elsewhere the money to pay such obligations. Moreover, the needs of the territory served by Long Island Lighting Company required constant extension of its plant. We may assume that prudent and conservative directors would, in such circumstances, have sought to obtain by an issue of bonds the money the corporation might require to refund its short term obligations and for new capital. We need not resort to doubtful inferences to find that the directors in their management of Long Island Lighting Company did not feel themselves restricted to conservative plans and methods. The evidence clearly indicates that.

Stocks, bonds, notes or other evidences of indebtedness "payable at periods of more than twelve months after the date thereof" could not be issued by Long Island Lighting Company without approval of the Public Service Commission obtained in accordance with section 69 of

the Public Service Law, Consol. Laws, ch. 48. The Long Island Lighting Company did in 1932 apply to the Public Service Commission for permission to issue approximately $15,000,000 of refunding bonds. The directors of the Long Island Lighting Company preferred, however, to borrow the moneys under a plan which would not be subject to the restrictions which the Public Service Commission might impose as conditions to its approval. An inference that the directors were influenced by that consideration when they sought to borrow the moneys for Long Island Lighting Company upon notes payable within one year from that date might reasonably be drawn from the evidence in this case. The transaction would not be unlawful for that reason. The Legislature has in the public interest provided that bonds or notes evidencing loans for a longer period than one year may be issued only with the approval of the Commission. The Legislature has not decreed that the public interest requires similar safeguards for issues where the loans became due within the year. The Legislature has drawn the line, and "the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it." Superior Oil Co. v. Mississippi, 280 U.S. 390, 395, 50 S.Ct. 169, 170, 74 L.Ed. 504, opinion by Mr. Justice Holmes. True, the inference might reasonably be drawn that the directors of the Long Island Lighting Company arranged that Empire Power Corporation should loan the money on short term notes with the expectation that Empire Power Corporation under their control would continue to renew the loans as they became due, until the time arrived when it would be convenient for Long Island Lighting Company to repay them. The directors regarded these loans as "investments" rather than temporary loans which would be paid at maturity. Nevertheless, the lender could have insisted upon payment of the loans as they became due, and the defendants can be charged with no wrong to the Empire Power Corporation on account of repeated renewals of the loans nor on account of the way in which they were handled, without proof that in these acts the defendants willfully failed to protect the interests of Empire Power Corporation in order to serve better their personal interests and the interests of the Long Island Lighting Company. There may be difference of opinion as to whether these defendants as directors of Empire Power Corporation acted wisely in the handling of the loans. There are many matters disclosed by the record which cast doubt upon the prudence, the wisdom, and the concern for the public interest shown by these directors. We are constrained, however, to agree with the Appellate Division that there is little, if any, evidence to sustain a finding that they have violated their trust or have failed to protect the interests of the Empire Power Corporation according to the dictates of their judgment, be that judgment good or bad.

It is argued, however, that the transactions in which the defendants acted as directors both of the Empire Power Corporation and the Long Island Lighting Company should be set aside because the dual position of these directors precluded an unprejudiced exercise of judgment. The dual position of the directors making the unprejudiced exercise of judgment by them more difficult, should lead the courts to scrutinize these transactions with care. Sage v. Culver, 147 N.Y. 241, 41 N.E. 513; Koral v. Savory, Inc., 276 N.Y. 215, 11 N.E.2d 883; Geddes

v. Anaconda Copper Mining Co., 254 U.S. 590, 41 S.Ct. 209, 65 L.Ed. 425; United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119. It does not, however, alone suffice to render the transactions void, and the provision of the certificate of incorporation of Empire Power Corporation expressly authorizing the directors to act even in matters where they have dual interest, has the effect of exonerating the directors, at least in part, "from adverse inferences which might otherwise be drawn against them." Spiegel v. Beacon Participations, 297 Mass. 398, 417, 8 N.E.2d 895, 907. We may point out here also that if by reason of these loans Empire Power Corporation should sustain a loss, the loss would fall primarily upon these defendants as owners of the entire capital stock. The proportion of stock of all classes owned by these defendants in Empire Power Corporation whose moneys they are claimed to have diverted wrongfully, is indeed, much greater than the proportion of the stock owned by them in Long Island Lighting Company which received these moneys. The loans were not excessive in relation to the capital assets and the income of the borrower as shown in the borrower's balance sheet. The evidence demonstrates that the defendants acting as the directors of the Long Island Lighting Company borrowed moneys from Empire Power Corporation because in their opinion the loans promoted the interests of the borrower and the stockholders of the borrower; the evidence does not demonstrate that the defendants acting as directors of the Empire Power Corporation in loaning its moneys to Long Island Lighting Company did not decide upon sufficient grounds that the loans would also promote the interests of the lender and its stockholders.

The judgment should be affirmed, without costs.

DESMOND, JUDGE (dissenting). At all the times of which we write, the individual defendants controlled both Long Island Lighting Company and Empire Power Corporation. In dealings between those corporations these individual defendants sat on both sides of the table. They caused Empire Power Corporation, from November, 1930, to February, 1933, to loan Long Island Lighting Company $5,330,000 on the latter's unsecured notes. These notes and various renewals thereof were all made for periods of less than a year. See Public Service Law, § 69. Interest has been paid regularly but, up to the beginning of this action, nothing was ever paid on principal. The lighting company needed these moneys—and used them—to pay off, from time to time, notes held by banks which were asking for payment. In 1930, when Empire made its first loan to the lighting company, the latter owed the banks more than $10,000,000 and found it increasingly difficult to persuade the banks to accept renewals of their unsecured notes. The banks had suggested to the individual defendants that the lighting company discontinue paying cash dividends, so that it might accumulate in its treasury funds with which to pay off the bank loans. This the individual defendants, who owned or controlled half of the lighting company's common stock, were unwilling to do. An application to the Public Service Commission for authority to issue mortgage bonds to raise money to pay off the banks was pending but undetermined. There was only one other convenient source of funds. A lender had

to be found who would supply, without security and without question, the cash needed from time to time to satisfy the banks. Such a lender was ready at hand in Empire Power Corporation, completely controlled by these individual defendants themselves.

During 1930 and 1932 these defendants arranged loans aggregating $4,500,000 from the power corporation to the lighting company, most, if not all, of the proceeds going to pay off the bank loans. In March, 1932, when the lighting company owed the power Corporation about $4,500,000 and the banks about $8,750,000, an agreement was made between the lighting company and the banks whereby the latter accepted renewals of their notes for six months, and agreed to accept renewals for another six months if necessary, on condition that the lighting company make certain payments which were intended to come from, and did come from, Empire Power Corporation. It was part of this arrangement that the whole of the lighting company's debt to Empire Power Corporation should be postdated to that of the banks, postdated rather than subordinated because it was felt that subordination "would be openly subject to attack on account of the unity of interest between Empire Power and Long Island Lighting."

A little later Empire's directors passed a resolution agreeing on behalf of Empire "to extend and keep extended the time of payment" of the lighting company's notes to Empire Power Corporation until the banks should be paid in full. An agreement to the same effect was made by defendant Phillips on behalf of Empire, in 1933, and approved by Empire's board of directors. Later that same year the Public Service Commission granted permission to the lighting company to sell the issue of bonds above referred to, but sale at the stipulated price was found to be impossible. Again the bank notes had to be renewed, and again Empire Power Corporation was caused to agree to subordinate its claims to those of the bank. Finally, in 1934, the authorized bond issue was sold by the lighting company under a contract which provided that the indebtedness to Empire Power Corporation would not be paid, discharged or secured by the issuance of any bonds of the lighting company secured by a lien prior to or on a parity with the lien of the bond issue. All of the proceeds of this bond issue went to the banks, none to Empire Power Corporation. In 1936 the lighting company paid off all its unsecured indebtedness, except that owing to Empire Power Corporation. Among the creditors so paid off were the common directors of the two corporations and their relatives and corporations controlled by them. Thus Empire Power Corporation, starting out with short term loans to the lighting company, ended up with what amounted to a "permanent investment" of $5,000,000 in the lighting company, in the form of unsecured notes, payment of which, if this suit fails, must await the pleasure of the defendants.

In this suit plaintiffs on behalf of Empire Power Corporation asked the court to compel Long Island Lighting Company to repay the moneys loaned to it by the Empire Corporation, to compel the individual defendants, as directors of Long Island Lighting Company, to pay that indebtedness if the lighting company does not, and to restrain the individual defendants from further extending the time of payment. Special Term found, as stated in its opinion, that the conduct of the

individual defendants, in making and renewing these loans, was biased in favor of the lighting company, and ordered judgment for plaintiff. The Appellate Division reversed on the law and the facts and rendered final judgment dismissing the complaint. Contracts between two corporations having common officers are, of course, not void per se (Burden v. Burden, 159 N.Y. 287, 54 N.E. 17; Continental Ins. Co. v. New York & H. R. Co., 187 N.Y. 225, 79 N.E. 1026), but are voidable by either corporation, irrespective of the balance of benefits (Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 121 N.E. 378; Munson v. Syracuse, G. & C. R. Co., 103 N.Y. 58, 8 N.E. 355), or by a court of equity at the instance of either corporation (or its stockholder), where it appears that such a contract was made in bad faith, fraud, other breach of trust or under circumstances preventing "an unprejudiced exercise of judgment." United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 264, 37 S.Ct. 509, 510, 61 L. Ed. 1119; Sage v. Culver, 147 N.Y. 241, 41 N.E. 513; Farmers' L. & T. Co. v. New York & Northern Ry. Co., 150 N.Y. 410, 44 N.E. 1043, 34 L.R.A. 76, 55 Am.St.Rep. 689; Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148; Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 41 S.Ct. 209, 65 L.Ed. 425; Koral v. Savory, Inc., 276 N.Y. 215, 11 N.E.2d 883. A court will not attempt to pass upon questions of expediency or to control the corporate managers in the faithful exercise of their discretion. City Bank Farmers' Trust Co. v. Hewitt Realty Co., 257 N.Y. 62, 177 N.E. 309, 76 A.L.R. 881; United Copper Securities Co. v. Amalgamated Copper Co., supra; Burden v. Burden, supra. To make a case for the invalidation of such a contract there must be shown circumstances tending to prove that the contract was made in bad faith, fraud or other breach of trust, including a biased exercise of judgment. Globe Woolen Co. v. Utica Gas & Electric Co., Sage v. Culver, United Copper Securities Co. v. Amalgamated Copper Co., Koral v. Savory, Inc., supra. Given such a showing, the burden is then upon those who would maintain the contract to establish its fairness (Sage v. Culver, supra), particularly when they themselves are shown to have exercised the dominating influence in effecting the contract. Geddes v. Anaconda Copper Mining Co., supra. Whether the particular contract between these two corporations having the same directors was or was not made under circumstances amounting to a breach of the directors' fiduciary duty, is a question of fact.

Here the individual defendants who arranged the loans by Empire Power Corporation to Long Island Lighting Company, were completely aware of the latter's financial difficulties at the times the loans and renewals were made. They and their families owned the majority of the lighting company's stock; they directed its policies and managed its affairs; some of them were unsecured creditors of the lighting company in substantial amounts. It was to their interest individually, that the lighting company's urgent need of funds to pay its unsecured and demanding bank creditors be met. They met it by loaning Empire's money to Long Island on such terms that Empire's capital funds were used to pay off Long Island's bank loans in part, then these loans were made subordinate to the balances owing to the banks and

finally remained wholly unpaid when all Long Island's other creditors of the same class were taken care of by the proceeds of a bond issue. The inference is unescapable that in the making of these loans, and renewals, the welfare of Empire Power Corporation was ignored and that the purpose of defendants was to benefit Long Island Lighting Company, and themselves. It is no answer to all this that Empire's financial structure may have resilience enough to absorb the risk or the damage of the loans, or that the individual defendant's stake in Empire is large and the plaintiff's small. Plain disclosure of the inequity of the situation and of the unfairness of the risk to the Empire Corporation, makes a strong appeal to the conscience of the court. It is not answered by defendants' protestations that Empire has a good investment in these loans, that they would surely be paid on a liquidation of the lighting company, that the lighting company's credit is good, etc., or by the provision in Empire Power Corporation's charter concerning contracts between that corporation and other corporations with the same officers or directors.

A court of equity in such a case as this does not stand aside and await the outcome of defendants' conduct. It acts promptly and effectively. It sets the whole transaction aside without waiting, or compelling minority stockholders to wait, to see whether those who unlawfully put a corporation's property at risk, may possibly at some undetermined time, have the skill, or luck, to get it back intact for the corporation.

The judgment of the Appellate Division should be reversed and that of the Special Term reinstated, with costs.

Judgment affirmed.

(d) Management Compensation

ROGERS v. HILL et al.

Supreme Court of the United States, 1933. 289 U.S. 582, 53 S.Ct. 731.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Consolidated suits by Richard Reid Rogers against George W. Hill and others and against Thomas R. Taylor and another. An order granting a temporary injunction having been reversed by the Circuit Court of Appeals [60 F.2d 109], the District Court vacated the temporary injunction and dismissed the bills of complaint upon the merits, which decree was affirmed by the Circuit Court of Appeals [62 F.2d 1079], and plaintiffs bring certiorari [289 U.S. 716, 53 S.Ct. 593, 77 L.Ed. 1469].

Decree of the Circuit Court of Appeals reversed, decree of the District Court dismissing the bills on the merits vacated, and case remanded to the District Court with directions.

MR. JUSTICE BUTLER delivered the opinion of the Court.

The American Tobacco Company is a corporation organized under the laws of New Jersey. The petitioner, plaintiff below, acquired in 1916 and has since been the owner of 200 shares of its common stock.

He also has 400 shares of common stock B. In accordance with by-law XII,[30] adopted by the stockholders at their annual meeting, March 13, 1912, the company for many years has annually paid its president and vice presidents large amounts in addition to their fixed salaries and other sums allowed them as compensation for services.[31]

Plaintiff maintains that the by-law is invalid and that, even if valid, the amounts paid under it are unreasonably large and therefore subject to revision by the courts. In March, 1931, he demanded that the company bring suit against the officers who have received such payments to compel them to account to the company for all or such part thereof as the court may hold illegal. The company, insisting that such a suit would be without basis in law or fact, refused to comply with his demand. He brought suit in the Supreme Court of New York against the president and some of the vice presidents to require them so to account, and joined the company as defendant. The case was re-

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30 "Section 1. As soon as practicable after the end of the year 1912 and of each year of the company's operations thereafter, the Treasurer of the Company shall ascertain the net profits, as hereinafter defined, earned by the Company during such year, and, if such net profits exceed the sum of $8,222,245.82, which is the estimated amount of such net profits earned during the year 1910 by the business that now belong to the Company, the Treasurer shall pay an amount equal in the aggregate to 10 per cent. of such excess to the President and five Vice-Presidents of the Company in the following proportions, to wit: One-fourth thereof, or 2½ per cent. of such amount, to the President; one-fifth of the remainder or 1½ per cent. of such amount, to each of the five Vice-Presidents as salary for the year, in addition to the fixed salary of each of said officers. * * *

"Section 3. For the purpose of this By-Law the net profits earned by the Company in any year shall consist of the net earnings made by the Company in its business as a manufacturer and seller of tobacco and its products after deducting all expenses and losses, such provisions as shall be determined by the Board of Directors of the Company for depreciation and for all outstanding trade obligations, and an additional amount equal to 6 per cent. dividends on $52,459,400 of its 6 per cent. preferred stock, to which profits shall be added, or from which profits shall be deducted, as the case may be, the Company's proportion (based on its stock holdings) of the net profits or losses for the year of its subsidiary companies engaged in the manufacture and sale of smoking tobacco, chewing tobacco, cigarettes, or little cigars, except earnings on preference shares of British-American Tobacco, Limited, and shares of Imperial Tobacco Company (of Great Britian and Ireland), Limited. * * *

"Section 5. This By-Law may be modified or repealed only by the action of the stockholders of the Company and not by the directors."

31 The statement below shows for the years specified the amounts alleged to have been paid by the company to the named defendants as salary, credits, and under by-law XII.

Hill	Salary	Cash Credits	By-Law	
1921			$89,833.84	Vice President
1922			82,902.61	
1923			77,336.54	
1924			88,894.26	
1925			97,059.38	
1926	$75,000		188,643.45	President
1927	75,000		268,761.45	
1928	75,000		280,203.68	
1929	144,500	$136,507.71	447,870.30	
1930	168,000	273,470.76	842,507.72	
Neiley				
1929	$33,333.32	$44,897.89	$115,141.87	
1930	50,000.00	89,945.52	409,495.25	
Riggio				
1929	$33,333.32	$45,351.40	$115,141.87	
1930	50,000.00	90,854.06	409,495.25	

moved to the federal court for the Southern District of New York. In May, 1931, plaintiff brought suit in that court against Taylor, a vice president, not a defendant in the earlier suit, to require him to account and made the company defendant. The cases were consolidated, plaintiff filed an amended complaint and defendants answered. The officers of the company now before the court are Hill, the president, Neiley, Riggio, and Taylor, vice presidents. The answer, after admissions, denials, and explanations, asserts several separate defenses. * * *[32] But plaintiff alleges that the measure of compensation fixed by it is not now equitable or fair. And he prays that the court fix and determine the fair and reasonable compensation of the individual defendants, respectively, for each of the years in question. The allegations of the complaint are not sufficient to permit consideration by the court of the validity or reasonableness of any of the payments on account of fixed salaries or of special credits or of the allotments of stock therein mentioned. Indeed, plaintiff alleges that other proceedings have been instituted for the restoration of special credits, and his suits to invalidate the stock allotments were recently considered here. Rogers v. Guaranty Trust Co., 288 U.S. 123, 53 S.Ct. 295, 77 L.Ed. 652. The only payments that plaintiff by this suit seeks to have restored to the company are the payments made to the individual defendants under the by-law.

We come to consider whether these amounts are subject to examination and revision in the District Court. As the amounts payable depend upon the gains of the business, the specified percentages are not per se unreasonable. The by-law was adopted in 1912 by an almost unanimous vote of the shares represented at the annual meeting and presumably the stockholders supporting the measure acted in good faith and according to their best judgment. The tabular statement in the margin shows the payments to individual defendants under the by-law. Plaintiff does not complain of any made prior to 1921. Regard is to be had to the enormous increase of the company's profits in recent years. The 2½ per cent. yielded President Hill $447,870.30 in 1929 and $842,507.72 in 1930. The 1½ per cent. yielded to each of the vice presidents, Neiley and Riggio, $115,141.86 in 1929 and $409,495.-25 in 1930 and for these years payments under the by-law were in addition to the cash credits and fixed salaries shown in the statement.

While the amounts produced by the application of the prescribed percentages give rise to no inference of actual or constructive fraud, the payments under the by-law have by reason of increase of profits become so large as to warrant investigation in equity in the interest of the company. Much weight is to be given to the action of the stockholders, and the by-law is supported by the presumption of regularity and continuity. But the rule prescribed by it cannot, against the protest of a shareholder, be used to justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property. The dissenting opinion of Judge Swan indicates the applicable rule: "If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part,

[32] The discussion of the power of stockholders to make by-laws appears infra. 1119.

and the majority stockholders have no power to give away corporate property against the protest of the minority." 60 F.(2d) 109, 113. The facts alleged by plaintiff are sufficient to require that the District Court, upon a consideration of all the relevant facts brought forward by the parties, determine whether and to what extent payments to the individual defendants under the by-laws constitute misuse and waste of the money of the corporation. [Citing cases.] * * *

The separate defenses set up in the answer to the amended complaint are: Failure of plaintiff to comply with Equity Rule 27 (28 USCA § 723), ratification, forum non conveniens, laches, and that the payments were justified. As they were not passed on below, we refrain from expressing opinion concerning them. The decree of the Circuit Court of Appeals is reversed, the decree of the District Court dismissing the bills on the merits is vacated, and the case is remanded to the District Court with directions to reinstate its decree granting injunction pendente lite and for further proceedings in conformity with this opinion.

It is so ordered.

ROGERS v. GUARANTY TRUST COMPANY OF NEW YORK et al.

Supreme Court of the United States, 1933. 288 U.S. 123, 53 S.Ct. 295.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Suits by Richard Reid Rogers against the Guaranty Trust Company of New York and others, and against the American Tobacco Company and another, to enjoin the execution of an employees' stock subscription plan [33] of the defendant American Tobacco Company. Judgment of dismissal [60 F.2d 106] was affirmed by the Circuit Court of Appeals [60 F.2d 114], and plaintiff brings certiorari [287 U.S. 586, 53 S.Ct. 80, 77 L.Ed. 652].

Judgment of Circuit Court of Appeals reversed, and judgment of District Court, entered on mandate, reversed, and case remanded with directions.

MR. JUSTICE STONE. (Dissenting) I think the court should decide this case on its merits in favor of the petitioner.

Respondent, the American Tobacco Company, organized under the laws of New Jersey, is a large and prosperous corporation, engaged in the manufacture and distribution of cigarettes and other forms of tobacco. It has upwards of 40,000 stockholders. At the commencement of this suit it had a board of sixteen directors, including a president, five vice presidents, a secretary and a treasurer, all actively engaged in its management. For many years these officers have received large annual fixed salaries, as well as large annual cash profit sharing bonuses paid under a by-law of the company, adopted in 1912. See Rogers v. Hill (C.C.A.) 60 F.2d 109. In the year 1930, the

[33] The plan was the same as the one in Rogers v. Hill, supra. The majority opinion dismissed on the ground of *forum non conveniens*, and is omitted here.

profit sharing bonus of the president, added to his fixed salary of $168,000, gave him a total compensation of over $1,010,000, which was further augmented by a special "credit" of $273,470. In the same year, four of the five vice presidents received an aggregate annual salary and bonus of more than $2,077,000. In addition, a number of stock subscription plans have from time to time been put into operation by the directors, without authority of the charter or by-laws of the corporation, or the knowledge or approval of its stockholders, by which they largely benefited. In that of 1926, the respondent Hill, the president and also a director of the company, acquired 8,000 shares of common stock, and other directors, who are respondents here, received substantial amounts. In that of 1929, one year before the transactions now complained of, 46,500 of 51,750 shares of common stock, purchased by the corporation and set aside for the purpose, were sold to the corporate directors at $47 per share less than market value. Convenient arrangements were made for postponed payment of the purchase price. Respondents received 23,050 shares, of which the president received 15,050.

On January 28, 1931, a new allotment of stock was made, which is the subject of this litigation. On that day, the Board of Directors (the president and officers constituting a majority of those in attendance) considered and passed upon the adequacy of the compensation which its members were then receiving for their services to the corporation, and the necessity of conferring further benefits on themselves in order to insure the continuance of those services. Having resolved these questions in their own favor, they proceeded to award additional benefits in the form of the privilege to subscribe to unissued common stock B of the corporation, at a small fraction of its market value. By resolution of that date, they put into effect a stock subscription plan by which 56,712 shares of unissued common stock B of the corporation were distributed in accordance with recommendations made by the president. Of this number 32,370, more than half, were allotted to the directors, of which 13,440 were allotted to the president. The remaining 24,342 shares were allotted in relatively small amounts to 525 employees. None of the recipients was of lower rank than factory subassistant. Four hundred and seventy-three received allotments of less than 100 shares each, the great majority receiving from 15 to 50 shares. The stated consideration for issue of the stock was a subscription price of $25 per share, the par value, and the services of the allottee, not specifically described, to be rendered to the American Tobacco Company for the remainder of the year.

The certificates of stock were to be delivered to the respondents, the Guaranty Trust Company of New York and an individual, as trustees. They were authorized to borrow money upon them to the extent of $25 per share, in order to effect immediate payment of the subscription price to the tobacco company, to apply dividends received on account of the purchase price to be paid by the allottees and to deliver the certificates to them after the close of the year, upon payment in full of their subscriptions. They were given discretion to waive performance of the stipulated service by any allottee and in the event that the subscriber was discharged or resigned from the employ of the company

within the year to cancel the subscription agreement or not, as they pleased.

On the day of the resolution allotting the stock, its market price was $112 per share, more than four times the subscription price. It was then paying, and has ever since paid, dividends at the rate of $5 per year, sufficient to pay the subscription price in five years. Valuing the subscription privilege by the difference between the subscription price and the market value of the shares the president received by the allotment the equivalent of $1,169,280, in addition to his annual compensation of more than $1,000,000. The stock subscription rights awarded the five vice presidents similarly valued, amounted to $1,451,-595. That the subscription privilege, accorded for the avowed purpose of assuring the continuance of these executives in the company's employ, was then and has been ever since of great value, upon any theory of valuation is not questioned.

Conceiving himself aggrieved by this transaction, petitioner, a nonassenting stockholder, brought two suits in the Supreme Court of New York, the state in which he resides, joining as defendants the American Tobacco Company, the trustees of the allotted stock, and certain of the directors, including the president, secretary, treasurer, and five vice presidents, one of whom has since died and two of whom were not served with process. Included in the relief sought was a decree that the corporation, its officers and directors be enjoined from carrying out the stock allotments and that the stock allotted to the directors be surrendered to the company. On motion of defendants, the tobacco company and a non-resident director, the causes were removed to the District Court for Southern New York, on grounds of diversity of citizenship of the parties to a separable controversy, and there consolidated.

Thus called upon in this suit to account for their stewardship and to justify their action, the defendants, the respondents here, place their whole reliance upon a statute of New Jersey in conformity with which, they contend, they secured, in advance the authorization of the stockholders to make the challenged allotments of stock.

Section 1, c. 175, of the New Jersey Laws for 1920 (Comp.St.Supp. N.J. § 47—183(a), authorizes any New Jersey corporation to provide and carry out a plan for "(a) the issue or the purchase and sale of its capital stock to any or all of its employees and those actively engaged in the conduct of its business or to trustees on their behalf * * * and for aiding any such employees and said other persons in paying for such stock by contributions, compensation for services, or otherwise. * * *" Section 2(b), Comp.St.Supp.N.J. § 47—184(b) provides that, where, as in this case, the corporation has been formed without charter or by-law provisions authorizing the issuance or the purchase and sale of stock for such purposes, "the board of directors shall first formulate such plan or plans and pass a resolution declaring that in its opinion the adoption thereof is advisable, and shall call a meeting of the stockholders to take action thereon. * * *" It requires an affirmative vote of two-thirds in interest of each class of stockholders, present at the meeting, for the adoption of the plan.

In June, 1930, the directors, purporting to act under this statute, presented to the stockholders, by notice of a special meeting, a so-called "plan" under which the employees of the corporation and those actively engaged in its business were to be permitted to subscribe to unissued shares of its common stock B. The notice of the meeting was accompanied by a document designated "Employees' Stock Subscription Plan," and by a copy of resolutions of the board of directors authorizing the submission of the plan to the stockholders, proposing a a reduction in the par value of the common stock and the non-voting common stock B from $50 to $25 per share, and an increase of the authorized common stock from 1,000,000 to 2,000,000 shares, and of the authorized common stock B from 2,000,000 to 4,000,000 shares, each stockholder to receive two shares of the new stock for one of the old. By thus increasing the authorized, unissued shares of common B, stock was to be made available for subscription by employees.

The Employees' Stock Subscription Plan proposed "to allot for subscription * * * by way of additional compensation for services to be rendered, shares of unissued common stock B * * * to such employees of the corporation and/or its subsidiaries and those actively engaged in the conduct of its or their business as may be selected. * * *" The prescribed method of execution of the plan was that "the Board of Directors may, at such time or times as it may determine * * * offer and allot such stock for subscription * * * in such amounts and proportions to such persons, at such prices, not less than the par value of the shares allotted, payable in full or in such installments, and upon such other terms and conditions, all as shall be determined with respect to each offering of stock to each individual pursuant to authority to be granted by the Board of Directors to the President for such purpose."

Accompanying the notice of the meeting was a circular letter by the president to stockholders, in which they were told of the prosperous condition of the company, that the purpose of the stock allotment plan was to encourage those who had made the company's success possible to continue in its employ, and that it was the expectation of the Board of Directors, if the program set forth in the notice of the meeting and accompanying documents should be approved by stockholders to declare an extra dividend of $4 per share on the common stock and common stock B, and to initiate regular quarterly dividends on the newly authorized shares of common stock and common stock B at the increased annual rate of $5 per share. The letter closed with a request to sign and return the enclosed proxy, thereby indicating "your approval of the proposed steps and your support of your Company's management."

Moved, perhaps, by these inducements, the proposal was approved at the meeting by vote of the requisite number of shares of each class.

No disclosure was made to the stockholders by the officers and directors of the stock subscription plans previously put into operation by them, without authority of the charter or by-laws or the knowledge and approval of the stockholders. No disclosure was made of the number or amounts of the annual cash bonuses which had been paid to the president and vice presidents of the company, under the by-law

adopted in 1912, and never, so far as appears, subsequently mentioned to the stockholders until after the stock allotments here involved. The only hint of the intention of the management to participate in the proposed Employees' Stock Subscription Plan was contained in a single sentence appearing in the Plan: "No employee, or person actively engaged in the conduct of the business of the Corporation, or its subsidiaries, shall be deemed ineligible to the benefits of the Plan by reason of being also a director of the Corporation or of any of its subsidiaries or of holding any office therein."

With all these facts presented by the pleadings, the District Court, acknowledging its jurisdiction both as a federal court and a court of equity to decide the cause on its merits, nevertheless, held that as the suit concerns the internal affairs of a New Jersey corporation, discretion should be exercised to dismiss it without prejudice to its maintenance in the courts of New Jersey. On appeal, the Circuit Court of Appeals for the Second Circuit, Judge Swan dissenting, considered the merits and upheld the legality of the stock allotments. The decree of dismissal was affirmed on the merits and the trial court has entered a final decree accordingly. This court now reverses that judgment, reestablishing the original decree of the trial court, on the ground that a proper exercise of judicial discretion requires that the cause should not be heard. Thus after approximately two years of litigation in state and federal courts, all of which could, and I think should, have decided the case on the merits, the plaintiff must now start the litigation afresh in the courts of New Jersey.

In determining whether the federal courts should decline to exercise the jurisdiction conferred on them by removal, the nature of this controversy and its merits cannot be ignored. I do not stop to consider numerous objections to the stock allotments, urged by petitioner, which are not without weight. It suffices for present purposes that no plan of sufficient definiteness to comply with the New Jersey statute was ever submitted to the stockholders for their approval; and that even if it be conceded that a "plan" was approved, the action of the directors in allotting the stock to themselves, in violation of their duty as fiduciaries, exceeded the authority conferred upon them by the stockholders, and was, therefore, ultra vires.

The statute directs that the board of directors shall "first formulate such plan," declare it "advisable," and call a meeting of stockholders to act on it. Without presenting for the consideration of the stockholders any workable plan of stock allotment, the directors, in effect, asked the stockholders to confer plenary authority on them to formulate a plan and to carry it into execution without any disclosure of its provisions. After the meeting, as before, no stockholder, not in the confidence of the directors, knew in what the plan consisted, who were the persons to participate in it, what principle was to control their selection or determine the amount of stock they were to receive, or the price they were to pay. It is a misuse of words of plain meaning to speak of such a proposal as a "plan," much less a formulated plan for stock allotment to employees, or as one which, in the form presented to the stockholders, the directors could have pronounced advisable or have carried into operation. It was no more than an

invitation to stockholders to abrogate the discretion which the statute vested in them to approve a formulated plan, having at least some aspects of definiteness, and vest in the directors powers which could be conferred on them only by charter amendment in the manner prescribed by the statute. The invitation was accompanied by a skillfully phrased suggestion that it was necessary to accept it in order to hold the services of employees, and that, if accepted, the directors would cause new benefits to flow into the pockets of stockholders in the form of extra and increased dividends. Such a maneuver cannot rightly be regarded as a compliance with the plain language of the statute, which requires the directors first to formulate a plan for stock allotment and declare it advisable, and then to submit it to the stockholders for their approval. If it were, it would be difficult to suggest any conceivable purpose of the statute which could not be thwarted by a similar procedure.

The respondents stand in no better position even if we assume that the proposal submitted to the stockholders was a formulated plan, within the meaning of the New Jersey statute. For in that case, authority for the directors' action must be found in the stockholders' approval of the proposal which they submitted, and we must interpret the proposal and the action taken by the stockholders in terms of their legitimate expectation that the directors were complying with their duty as fiduciaries and not dealing with them at arm's length. They were entitled to read the proposal in the light of the fundamental duty of directors to derive no profit from their own official action, without the consent of the stockholders, obtained after full and fair revelation of every circumstance which might reasonably influence them to withhold their consent. Wardell v. Railroad Co., 103 U.S. 651, 26 L.Ed. 509; General Investment Co. v. American Hide & Leather Co., 97 N.J.Eq. 230, 233, 127 A. 659; see United States Steel Corp. v. Hodge, 64 N.J.Eq. 807, 813, 54 A. 1, 60 L.R.A. 742; Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 489, 121 N.E. 378; compare Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545, 62 A.L.R. 1; Wendt v. Fischer, 243 N.Y. 439, 154 N.E. 303. They were entitled to assume that the proposal involved nothing which did not fairly appear on its face and above all that it was not a cloak for a scheme by which the directors were to enrich themselves in great amounts at the expense of the corporation, of whose interests they were the legal guardians.

The respondents must, therefore, rest their case on the bare statement in their proposal to the stockholders that no employee or person actively engaged in the business of the company "shall be deemed ineligible to the benefits of the Plan," because a director or officer. But it would be extravagant to say that these words, addressed by men in the position of trustees to their beneficiaries, gave warning of the wholesale gratuities which the directors subsequently bestowed upon themselves. No more extensive authority could be derived from this language than the disclosure which it made. By consenting that the directors should be "eligible" to share in a plan avowedly for the benefit of employees, the stockholders did not consent that they should be the chief beneficiaries of their own unrestrained munificence, or that they should add any new bounties to the unrevealed stock allot-

ments and bonuses which the directors had previously enjoyed in secrecy. Even if the stockholders consented that some of the directors should be eligible to benefit from action taken by other disinterested directors, they certainly did not consent that the allotments should be made by a group of directors who, because of the magnitude of the benefits they anticipated for themselves, were obviously incapable of passing an independent and unbiased judgment upon the propriety of the distribution which they co-operated in making to each other. Respondents' contention that if the directors were unable to vote on each other's participation no plan could be put into effect under which a majority of the directors were to participate, is without weight, for it obviously could be if the statute were followed and the plan revealed in its entirety to the stockholders.

To surmount these difficulties, respondents point to the fact that a representative of petitioner stated at the stockholders' meeting that favorable action on the proposal might result in the issuance of a large amount of stock to employees, including officers and directors, without adequate consideration, and that this did not induce the stockholders to express their disapproval. It is unnecessary to speculate whether this outcome is to be attributed to the fact that those present, being without the aid of prevision, regarded the prediction as too improbable to be credited, or to the fact that those who attended the meeting were not, for the most part, the stockholders, but the recipients of their proxies selected by the management of the corporation for the occasion. A statement made to them would, as a New Jersey court has said, fall "upon ears not allowed to hear and minds not permitted to judge; upon automatons, whose principals are uninformed of their own injury." See Berendt v. Bethlehem Steel Corp., 108 N.J.Eq. 148, 151, 154 A. 321, 322. In any event it is enough that neither in the notice of meeting and accompanying documents, which the stockholders saw and on which they relied, nor at the meeting itself, did the officers and directors disclose that such was their purpose.

We need not conjecture whether, if the directors had had the hardihood to disclose in advance the benefits which they were to award to themselves, the stockholders would nevertheless have given their approval. Nor is it important that these directors have successfully managed the corporation and that under their direction it has earned large profits for its stockholders. Their business competence did not confer on them the privilege of making concealed or unauthorized profits or relieve them of the elementary obligation which the law imposes on all corporate directors to deal frankly and openly with stockholders in seeking their consent to benefit personally by reason of their relationship to the corporation.

The directors, having failed to comply with petitioner's seasonable demand that they exercise their authority to bring this suit in the name of the corporation, petitioner was not required by general equitable principles or by Equity Rule 27 to appeal to the stockholders before bringing it, as the action complained of here was not one which the stockholders could ratify. * * *

3. MANAGEMENT RESPONSIBILITY TO STOCKHOLDERS

Originally the corporate management consisted of that group—usually the board of directors—in whom was vested the exercise of the corporate powers. This remains a technical rule today, though it has been expanded to include senior or responsible officers.

But it presently became obvious that the titular management might or might not be the actual management. The directors who were "dummies"—weak men who merely did what they were told by someone else—might be technically responsible as a management; but the real management might be men higher up. The business responsibility rested on the dominant individual or individuals, no matter what office he or they held, or whether he or they did not have office at all.

The law has posited a set of standards for corporate managements. In terms these are apt to be the same year by year; in application, they are apt to change.

A management which is strictly limited by law to performing certain functions so that it has a minimum of discretion manifestly cannot be held to the same standard of responsibility as can a management with absolute control—at least so far as business sense would indicate. Where the participants themselves give instructions or mark out a line of policy, naturally they and not the officers are responsible for the results of that line.

Where, however, the management is chosen by the participants and represents them, but has full discretion, the participants are relatively more helpless; the management is relatively more powerful; and as a business matter more is expected in the way of good faith, ability, and success. But to the extent that the management has been chosen by the participants, there is at least a presumption that this management is protecting the interests of those who chose it.

Where, however, the management is not chosen by the participants, and has complete discretion, it is manifest that the participants are, from the business point of view, completely in the hands of a group over whom they have no control whatever. This situation may arise as a matter of fact or as a matter of law. In practice the managements of very large corporations (United States Steel Co., American Telephone and Telegraph Co.), though they are elected by the shareholders, are practically independent of the shareholders since the distribution of stock is so wide and the expense of changing a management so great that from mere inertia boards of directors are re-elected year after year, or virtually nominate their own successors. Legal devices have been invented to secure the same result; for instance, non-voting stock.

The problem of the enhanced liability of managements depending on their power is discussed in Berle: Studies in the Law of Corporation Finance: "Non-Voting Stock and 'Bankers' Control.'" This thesis has been questioned by Wood, "Status of Management Stockholders," 38 Yale L.J. 57, 1928.

CARPENTER v. DANFORTH.

Supreme Court of New York, 1868. 52 Barb. 581.

Action to have a sale of stock set aside, on the ground of fraud and undue influence.

SUTHERLAND, J. The defendant Danforth bought of the plaintiff, as administrator, in December, 1862, one hundred and thirty-six shares of the stock of "The National Bank Note Company," a New York corporation, for $60 a share, the par value being $50 a share. When Danforth bought the stock he was one of the trustees or directors of the corporation, and had been from its organization in 1859.

The purpose of this action is, to have the sale of the stock declared void, and the plaintiff restored to the rights and interests which he would have had, had the sale not been made, upon the ground of fraud and undue influence.

There is a preliminary question of law, of great, perhaps I should say, of controlling importance. The counsel for the plaintiff insists, and has submitted an elaborate and very able brief to show, that from the relation between Danforth as a trustee, or director, and the plaintiff as a share or stockholder, undue influence on the one side, and a corresponding trust and confidence on the other side, is to be presumed; so that, applying to this case a well known principle of equity applicable to dealings and contracts of parties, between whom there was a trust or confidential relation, the result would be that the sale or transaction must be declared void, unless the proofs show, independent of the question of actual or positive fraud, not only that Danforth paid a full and fair price for the stock, but also that he disclosed to the plaintiff every fact or circumstance known to him, Danforth, and not known to the plaintiff, material on the question of the value of the stock. * * *

There was certainly a trust relation between the plaintiff as the holder of, or as the person having the legal title to, the shares of stock, and the defendant Danforth, as a trustee or director. A corporation aggregate can only act by agents. Its trustees or directors are its agents for managing its affairs. They are such agents, viewing the corporation either in the abstract, as an immaterial thing, of legislative creation, with a name and certain powers and rights given by law, or as composed of its corporators, or shareholders, having the right to share *pro rata* in its dividends. There is, therefore, a certain trust relation between the shareholders and the directors of a corporation; but the trust put in the directors usually extends, and I must assume that in this case it extended only to the management of the general affairs of the corporation, with a view to dividends of profits; and, therefore, that the trust relation between the plaintiff and the defendant Danforth, extended no farther. The title to the property of a corporation is in neither the directors nor shareholders. It is in the corporation as an abstract, immaterial thing of legal creation. The directors are not trustees for the sale of the stock of the corporation. They have no power, *as directors,* to sell stock; they have no power to sell any stock but their own. The defendant Dan-

forth, was not a trustee for the sale of the plaintiff's stock. The plaintiff's *stock* was not the subject of trust between them, nor had the trust relation between them any connection with the plaintiff's stock, except so far as the good or bad management of the general affairs of a corporation by its directors, indirectly affects the value of its stock. * * * [Complaint dismissed.]

STRONG v. REPIDE.

Supreme Court of the United States, 1909. 213 U.S. 419, 29 S.Ct. 521.

In error to and appeal from the Supreme Court of the Philippine Islands to review a judgment which, reversing the judgment of the Court of First Instance of the City of Manila, dismissed the complaint in an action to recover certain shares of corporate stock from the purchaser on the ground that such shares were sold by plaintiff's agent without authority, and that the purchaser had fraudulently concealed facts affecting the value of such stock. Reversed. The judgment of the Court of First Instance affirmed.

MR. JUSTICE PECKHAM. * * * The question in this case, therefore, is whether, under the circumstances above set forth, it was the duty of the defendant, acting in good faith, to disclose to the agent of the plaintiff the facts bearing upon or which might affect the value of the stock.

If it were conceded, for the purpose of the argument, that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the shares of the company before he purchases any from a shareholder, yet there are cases where, by reason of the special facts, such duty exists. The supreme courts of Kansas and of Georgia have held the relationship existed in the cases before those courts because of the special facts which took them out of the general rule, and that, under those facts, the director could not purchase from the shareholder his shares without informing him of the facts which affected their value. Stewart v. Harris, 69 Kan. 498, 66 L.R.A. 261, 105 Am.St.Rep. 178, 77 P. 277, 2 A. & E. Ann.Cas. 873; Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232. The case before us is of the same general character. On the other hand, there is the case of Tippecanoe County v. Reynolds, 44 Ind. 509–515, 15 Am.Rep. 245, where it was held (after referring to cases) that no relationship of a fiduciary nature exists between a director and a shareholder in a business corporation. Other cases are cited to that effect by counsel for defendant in error. These cases involved only the bare relationship between director and shareholder. It is here sought to make defendant responsible for his actions, not alone and simply in his character as a director, but because, in consideration of all the existing circumstances above detailed, it became the duty of the defendant, acting in good faith, to state the facts before making the purchase. That the defendant was a director of the corporation is but one of the facts upon which the liability is asserted, the existence of all the others in

addition making such a combination as rendered it the plain duty of the defendant to speak. He was not only a director, but he owned three fourths of the shares of its stock, and was, at the time of the purchase of the stock, administrator general of the company, with large powers, and engaged in the negotiations which finally led to the sale of the company's lands (together with all the other friar lands) to the government at a price which very greatly enhanced the value of the stock. He was the chief negotiator for the sale of all the lands, and was acting substantially as the agent of the shareholders of his company by reason of his ownership of the shares of stock in the corporation and by the acquiescence of all the other shareholders, and the negotiations were for the sale of the whole of the property of the company. By reason of such ownership and agency, and his participation as such owner and agent in the negotiations then going on, no one knew as well as he the exact condition of such negotiations. No one knew as well as he the probability of the sale of the lands to the government. No one knew as well as he the probable price that might be obtained on such sale. The lands were the only valuable asset owned by the company. Under these circumstances, and before the negotiations for the sale were completed, the defendant employs an agent to purchase the stock, and conceals from the plaintiff's agent his own identity and his knowledge of the state of the negotiations and their probable result, with which he was familiar as the agent of the shareholders, and much of which knowledge he obtained while acting as such agent, and by reason thereof. The inference is inevitable that, at this time, he had concluded to press the negotiations for a sale of the lands to a successful conclusion; else, why would he desire to purchase more shares which, if no sale went through, were in his opinion, worthless because of the failure of the government to properly protect the lands in the hands of their then owners? The agent of the plaintiff was ignorant in regard to the state of the negotiations for the sale of the land, which negotiations and their probable result were a most material fact affecting the value of the shares of stock of the company, and he would not have sold them at the price he did had he known the actual state of the negotiations as to the lands, and that it was the defendant who was seeking to purchase the stock. Concealing his identity when procuring the purchase of the stock, by his agent, was in itself strong evidence of fraud on the part of the defendant. Why did he not ask Jones, who occupied an adjoining office, if he would sell? But, by concealing his identity, he could, by such means, the more easily avoid any questions relative to the negotiations for the sale of the lands and their probable result, and could also avoid any actual misrepresentations on that subject, which he evidently thought were necessary in his case to constitute a fraud. He kept up the concealment as long as he could, by giving the check of a third person for the purchase money. Evidence that he did so was objected to on the ground that it could not possibly even tend to prove that the prior consent to sell had been procured by the subsequent check given in payment. That was not its purpose. Of course, the giving of the check could not have induced the prior consent, but it was proper evidence as tending to show that the concealment of identiy was not

a mere inadvertent omission, an omission without any fraudulent or deceitful intent, but was a studied and intentional omission, to be characterized as part of the deceitful machinations to obtain the purchase without giving any information whatever as to the state and probable result of the negotiations, to the vendor of the stock, and to, in that way, obtain the same at a lower price. After the purchase of the stock he continued his negotiations for the sale of the lands, and finally, he says, as administrator general of the company, under the special authority of the shareholders, and as attorney in fact, he entered into the contract of sale December 21, 1903. The whole transaction gives conclusive evidence of the overwhelming influence defendant had in the course of the negotiations as owner of a majority of the stock and as agent for the other owners, and it is clear that the final consummation was in his hands at all times. If, under all these facts, he purchased the stock from the plaintiff, the law would indeed be impotent if the sale could not be set aside or the defendant cast in damages for his fraud.

The supreme court of the islands, in holding that there was no fraud in the purchase, said that the responsibility of the directors of a corporation to the individual stockholders did not extend beyond the corporate property actually under the control of the directors; that they did not owe any duty to the members in respect to their individual stock, which would prevent them from purchasing the same in the usual manner. While this may, in general, be true, we think it is not an accurate statement of the case, regard being had to the facts above mentioned.

It is said that, by the Code of Commerce of the Philippine Islands the directors are declared to be mandatories of the society, and that, by article 1459 of the Spanish Civil Code, they are prohibited from acquiring by purchase, even at public or judicial auction, the property the administration or sale of which may have been intrusted to them, and that this is the extent of the prohibition. This provision has no reference to the purchase for himself, under such facts as existed here, by an officer of a corporation, of stock in the corporation owned by another. The case before us seems a plain one for holding that, under the circumstances detailed, there was a legal obligation on the part of the defendant to make these disclosures.

It is further objected, however, that the plaintiff, Mrs. Strong, denied that she had ever authorized her agent to sell this stock, and therefore, by her own evidence, there had never been any consent by her, obtained by fraud or otherwise, because there had never been any consent at all. There is nothing in this objection. Mrs. Strong contended that such authority as she had given never authorized her agent to sell this stock. That had nothing to do with the obligation of the defendant to make the disclosure of the facts already adverted to before the purchase of the stock from plaintiff's agent, and if, by reason of such failure, the defendant was guilty of a fraud in procuring the purchase from the plaintiff's agent, it was a fraud for which he became liable to the plaintiff, even though the plaintiff maintained that her agent was not authorized to sell. The court held that he was authorized, and therefore, if he sold by reason of the fraud committed

by defendant, the plaintiff was thereby injured and the defendant became liable. In legal effect her consent was obtained by the fraud.

We have not overlooked the objections made in regard to the form of the judgment in the court of first instance, but are of opinion that such objections are not of a material nature, and we are disposed to follow the course pursued by that court in this case.

Other objections made by the defendant's counsel we have examined, but do not regard them as important. We therefore reverse the judgment of the Supreme Court, dismissing the complaint, and affirm that of the Court of First Instance, and it is so ordered.

CONNOLLY v. SHANNON.

Court of Chancery, New Jersey, 1929. 105 N.J.Eq. 155, 147 A. 234.

Suit by Michael T. Connolly against Joseph Shannon. On motion to strike out bill of complaint. Granted.

BERRY, VICE CHANCELLOR. The bill alleges that the complainant was the owner of 60 shares of the capital stock of the Mercantile Trust Company of Jersey City, and was also a director of the corporation, and that the defendant was president, director, and chairman of the executive committee of the board of directors of said company; that the defendant, as such president and chairman, prior to the date mentioned in the bill of complaint, had been negotiating for the sale and merger of said company with another bank, and with knowledge of "the practical certainty of a sale and merger being consummated on the basis of a value of at least $2,500 for each share of stock of said Mercantile Trust Company, and without informing complainant of any such facts, as it was his duty to do, offered to buy from complainant his said stock at $1,400 per share," and that complainant, without any knowledge of the said facts, and "relying upon the relationship of trust that existed between said Joseph Shannon and himself with regard to the affairs of said Mercantile Trust Company," sold 50 shares of his said stock to the defendant at $1,400 per share; that later said proposed merger was effected on a basis which gave to each stockholder of Mercantile Trust Company, for each share of stock held by him, $1,397.73 in cash and 8 shares of Commercial Trust Company of New Jersey, of the market value of $220 per share; and that upon learning of the proposed sale and merger complainant repudiated his sale of stock to the defendant, and offered to return to him the purchase price, which offer the defendant refused.

The bill further alleges that the defendant on said merger received for the 50 shares of stock purchased from the complainant the sum of $69,286.50 cash and 400 shares of Commercial Trust Company of New Jersey; also that 400 shares of stock of Commercial Trust Company are not readily obtainable in the open market. The complainant renews his offer to pay the defendant the amount of the purchase price of said 50 shares of stock, and demands that the defendant turn over to him what he received in exchange for said stock on said merger. The bill prays an accounting and a decree directing the defendant to

transfer and deliver to the complainant the proceeds of complainant's stock on said merger.

This motion is based upon the ground that the bill of complaint discloses no cause of action. My decision on this motion is controlled by the decision of the Court of Errors and Appeals in Crowell v. Jackson, 53 N.J.Law, 656, 23 A. 426, 427. It was there held:

"A director or the treasurer of a corporation is not, because of his office, in duty bound to disclose to an individual stockholder, before purchasing his stock, that which he may know as to the real condition of the corporation affecting the value of that stock. He is, to some extent, trustee for the stockholders as a body in respect to the property and business of the corporation, but does not sustain that relation to individual stockholders with respect to their several holdings of stock, over which he has no control."

There seem to be two distinct lines of authorities on the point involved on this motion; that is, whether or not an officer and director of a corporation occupies such a fiduciary relation toward individual stockholders as to make it the duty of such officer and director to disclose to an individual stockholder, before purchasing his stock, that which he may know as to the real conditions of the corporation affecting the value of that stock. The majority view, apparently, is that adopted by the Court of Errors and Appeals in Crowell v. Jackson, supra, which holds that he does not occupy such fiduciary relation. The minority view is that expressed in Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232, cited by counsel for the complainant, and which holds that such fiduciary relation does exist. For a discussion of the conflicting rules, see L.R.A.1916B, page 706, note; Fletcher's Cyclopedia, of Corporations, vol. 4, § 2464; and Corpus Juris, vol. 14a, p. 128, par. 1896.

Since our court of last resort has adopted the majority rule my own view as to which of the rules is the more consonant with equity and justice is immaterial. I will therefore advise an order striking out the bill of complaint.

[aff'd. per curiam, 107 N.J.Eq. 180, 151 A. 905, 1930]

GOODWIN v. AGASSIZ et al.

Supreme Judicial Court of Massachusetts, 1933. 283 Mass. 358, 186 N.E. 659.

Suit by Homer Goodwin against Rodolphe L. Agassiz and another. From a decree dismissing plaintiff's bill plaintiff appeals.

Affirmed.

RUGG, CHIEF JUSTICE. A stockholder in a corporation seeks in this suit relief for losses suffered by him in selling shares of stock in Cliff Mining Company by way of accounting, rescission of sales, or redelivery of shares. The named defendants are MacNaughton, a resident of Michigan not served or appearing, and Agassiz, a resident of this commonwealth, the active party defendant. * * * The facts thus displayed are these: The defendants, in May, 1926, purchased through brokers on the Boston stock exchange seven hundred shares of stock of the Cliff Mining Company which up to that time the plaintiff

had owned. Agassiz was president and director and MacNaughton a director and general manager of the company. They had certain knowledge, material as to the value of the stock, which the plaintiff did not have. The plaintiff contends that such purchase in all the circumstances without disclosure to him of that knowledge was a wrong against him. That knowledge was that an experienced geologist had formulated in writing in March, 1926, a theory as to the possible existence of copper deposits under conditions prevailing in the region where the property of the company was located. That region was known as the mineral belt in Northern Michigan, where are located mines of several copper mining companies. Another such company, of which the defendants were officers, had made extensive geological surveys of its lands. In consequence of recommendations resulting from that survey, exploration was started on property of the Cliff Mining Company in 1925. That exploration was ended in May, 1926, because completed unsuccessfully, and the equipment was removed. The defendants discussed the geologist's theory shortly after it was formulated. Both felt that the theory had value and should be tested, but they agreed that, before starting to test it, options should be obtained by another copper company of which they were officers on land adjacent to or nearby in the copper belt, that if the geologist's theory were known to the owners of such other land there might be difficulty in securing options, and that that theory should not be communicated to any one unless it became absolutely necessary. Thereafter, options were secured which, if taken up would involve a large expenditure by the other company. The defendants both thought, also that, if there was any merit in the geologist's theory, the price of Cliff Mining Company stock in the market would go up. Its stock was quoted and bought and sold on the Boston Stock Exchange. Pursuant to agreement, they bought many shares of that stock through agents on joint account. The plaintiff first learned of the closing of exploratory operations on property of the Cliff Mining Company from an article in a paper on May 15, 1926, and immediately sold his shares of stock through brokers. It does not appear that the defendants were in any way responsible for the publication of that article. The plaintiff did not know that the purchase was made for the defendants and they did not know that his stock was being bought for them. There was no communication between them touching the subject. The plaintiff would not have sold his stock if he had known of the geologist's theory. The finding is express that the defendants were not guilty of fraud, that they committed no breach of duty owed by them to the Cliff Mining Company, and that that company was not harmed by the nondisclosure of the geologist's theory, or by their purchases of its stock, or by shutting down the exploratory operations.

The contention of the plaintiff is that the purchase of his stock in the company by the defendants without disclosing to him as a stockholder their knowledge of the geologist's theory, their belief that the theory was true, had value, the keeping secret the existence of the theory, discontinuance by the defendants of exploratory operations begun in 1925 on property of the Cliff Mining Company and their plan ultimately to test the value of the theory, constitute actionable wrong for which he as stockholder can recover.

The trial judge ruled that conditions may exist which would make it the duty of an officer of a corporation purchasing its stock from a stockholder to inform him as to knowledge possessed by the buyer and not by the seller, but found, on all the circumstances developed by the trial and set out at some length by him in his decision, that there was no fiduciary relation requiring such disclosure by the defendants to the plaintiff before buying his stock in the manner in which they did.

The question presented is whether the decree dismissing the bill rightly was entered on the facts found.

The directors of a commercial corporation stand in a relation of trust to the corporation and are bound to exercise the strictest good faith in respect to its property and business. Elliott v. Baker, 194 Mass. 518, 523, 80 N.E. 450; Beaudette v. Graham, 267 Mass. 7, 165 N.E. 671; L. E. Fosgate Co. v. Boston Market Terminal Co., 275 Mass. 99, 107, 175 N.E. 86. The contention that directors also occupy the position of trustee toward individual stockholders in the corporation is plainly contrary to repeated decisions of this court and cannot be supported. In Smith v. Hurd, 12 Metc. 371, 384, 46 Am.Dec. 690, it was said by Chief Justice Shaw: "There is no legal privity, relation, or immediate connexion, between the holders of shares in a bank, in their individual capacity, on the one side, and the directors of the bank on the other. The directors are not the bailees, the factors, agents or trustees of such individual stockholders." In Stewart v. Joyce, 201 Mass. 301, 311, 312, 87 N.E. 613, and Lee v. Frisk, 222 Mass. 424, 426, 109 N.E. 835, the same principle was reiterated. In Blabon v. Hay, 269 Mass. 401, 407, 169 N.E. 268, 271, occurs this language with reference to sale of stock in a corporation by a stockholder to two of its directors: "The fact that the defendants were directors created no fiduciary relation between them and the plaintiff in the matter of the sale of his stock."

The principle thus established is supported by an imposing weight of authority in other jurisdictions. * * * A rule holding that directors are trustees for individual stockholders with respect to their stock prevails in comparatively few states; but in view of our own adjudications it is not necessary to review decisions to that effect. * * *

While the general principle is as stated, circumstances may exist requiring that transactions between a director and a stockholder as to stock in the corporation be set aside. The knowledge naturally in the possession of a director as to the condition of a corporation places upon him a peculiar obligation to observe every requirement of fair dealing when directly buying or selling its stock. Mere silence does not usually amount to a breach of duty, but parties may stand in such relation to each other that an equitable responsibility arises to communicate facts. Wellington v. Rugg, 243 Mass. 30, 35, 136 N.E. 831. Purchases and sales of stock dealt in on the stock exchange are commonly impersonal affairs. An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares. Business of that nature is a

matter to be governed by practical rules. Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud. On the other hand, directors cannot rightly be allowed to indulge with impunity in practices which do violence to prevailing standards of upright business men. Therefore, where a director personally seeks a stockholder for the purpose of buying his shares without making disclosure of material facts within his peculiar knowledge and not within reach of the stockholder, the transaction will be closely scrutinized and relief may be granted in appropriate instances. [Citing cases.] The applicable legal principles "have almost always been the fundamental ethical rules of right and wrong." Robinson v. Mollett, L. R. 7 H. L. 802, 817.

The precise question to be decided in the case at bar is whether on the facts found the defendants as directors had a right to buy stock of the plaintiff, a stockholder. Every element of actual fraud or misdoing by the defendants is negatived by the findings. Fraud cannot be presumed; it must be proved. Brown v. Little, Brown & Co., Inc., 269 Mass. 102, 117, 168 N.E. 521, 66 A.L.R. 1284. The facts found afford no ground for inferring fraud or conspiracy. The only knowledge possessed by the defendants not open to the plaintiff was the existence of a theory formulated in a thesis by a geologist as to the possible existence of copper deposits where certain geological conditions existed common to the property of the Cliff Mining Company and that of other mining companies in its neighborhood. This thesis did not express an opinion that copper deposits would be found at any particular spot or on property of any specified owner. Whether that theory was sound or fallacious, no one knew, and so far as appears has never been demonstrated. The defendants made no representations to anybody about the theory. No facts found placed upon them any obligation to disclose the theory. A few days after the thesis expounding the theory was brought to the attention of the defendants, the annual report by the directors of the Cliff Mining Company for the calendar year 1925, signed by Agassiz for the directors, was issued. It did not cover the time when the theory was formulated. The report described the status of the operations under the exploration which had been begun in 1925. At the annual meeting of the stockholders of the company held early in April, 1926, no reference was made to the theory. It was then at most a hope, possibly an expectation. It had not passed the nebulous stage. No disclosure was made of it. The Cliff Mining Company was not harmed by the nondisclosure. There would have been no advantage to it, so far as appears, from a disclosure. The disclosure would have been detrimental to the interests of another mining corporation in which the defendants were directors. In the circumstances there was no duty on the part of the defendants to set forth to the stockholders at the annual meeting their faith, aspirations and plans for the future. Events as they developed might render advisable radical changes in such views. Disclosure of the

theory, if it ultimately was proved to be erroneous or without foundation in fact, might involve the defendants in litigation with those who might act on the hypothesis that it was correct. The stock of the Cliff Mining Company was bought and sold on the stock exchange. The identity of buyers and seller of the stock in question in fact was not known to the parties and perhaps could not readily have been ascertained. The defendants caused the shares to be bought through brokers on the stock exchange. They said nothing to anybody as to the reasons actuating them. The plaintiff was no novice. He was a member of the Boston stock exchange and had kept a record of sale of Cliff Mining Company stock. He acted upon his own judgment in selling his stock. He made no inquiries of the defendants or of other officers of the company. The result is that the plaintiff cannot prevail.

Decree dismissing bill affirmed with costs.

4. MANAGEMENT RESPONSIBILITY TO CREDITORS

ALLEN et al. v. COCHRAN et al.

Supreme Court of Louisiana, 1926. 160 La. 425, 107 So. 292.

Action by F. C. Allen and others against S. H. Cochran and others. From a judgment of dismissal, plaintiffs appeal. Affirmed.

BRUNOT, J. The plaintiffs were depositors in the Plain Dealing Bank, a banking corporation, domiciled at Plain Dealing, La., and the defendants were the officers and directors of the bank.

The bank failed, and this suit is against its officers and directors for the losses sustained by the plaintiffs as a result of the failure.

The petition charges the defendants with negligence, inefficiency, and omissions of duty in their conduct of the business and affairs of the bank. It alleges that their negligence and omissions of duty enabled the cashier of the bank to embezzle and dissipate its funds, and to wreck the institution. It is upon these allegations that plaintiffs have based their suit. They do not allege fraud, conspiracy, malfeasance, or actionable deceit. The prayer of their petition is for a judgment jointly and in solido against the defendants and in favor of each plaintiff for the sums, respectively, each is alleged to have lost by reason of the bank's failure.

Defendants excepted to the suit upon the grounds that the petition did not disclose a right of action or cause of action. From a judgment sustaining the exceptions and rejecting the demands of plaintiffs they appealed.

There is no statute or law of this state authorizing the creditors of a corporation to bring a personal action against its officers or directors for the recovery of losses resulting from their negligent management of the affairs of the corporation. The officers and directors are merely the agents of the corporation, and, except for acts of malfeasance, they are answerable to it alone. The depositors in a bank are creditors of the bank, and there is no contractual relation between the officers and directors of a bank and its creditors. The corporation itself and, in proper cases, the stockholders have a right of action

against the agents of the corporation for gross negligence, maladministration of the corporate affairs, and omissions of official duty, but a creditor of the corporation has no such right.

Plaintiffs cite 8 Mart. (N.S.) 68, and 3 La. 568, in support of their contention that, where depositors in a bank suffer loss by reason of the gross negligence of the officials of the bank, there is a cause of action in favor of such depositors directly against the negligent officials. The two cases cited are but one case, viz. Percy et al. v. Milladon et al. The plaintiffs in the case were stockholders of the Planters' Bank of Louisiana, and the defendants were its officers and other stockholders of the bank. The suit was for a liquidation of the affairs of the bank and a division of its funds. When the case was first brought up on appeal, it was remanded, and was finally decided on the second appeal. This case has no application to the contention here made by plaintiffs.

It is also contended that directors of a bank are quasi public officials, and delinquency in the performance of their ministerial duties gives rise to a civil action in favor of a person who is injured thereby. Plaintiffs cite State v. Hunsicker, 90 So. 765, 150 La. 475, and section 1, Act 193 of 1910. Plaintiffs concede that bank directors are not eo nomine public officials, but it is contended that, as section 1 of Act 193 of 1910 provides that only stockholders of a bank are eligible as directors, and that each director, before entering upon his duties as such, shall take an oath to administer the bank's affairs diligently and honestly, therefore bank directors become quasi public officials. It is true that they and their corporation serve the public, but they do so for private gain. They are not charged with any public function, and they perform no public duty. A public officer is an agent of the state or of one of its subdivisions.

"A public officer is an individual who has been appointed or elected in the manner prescribed by law, and who exercises the functions concerning the public assigned to him by law." Am. & Eng. Ency. (2d Ed.) 23, p. 322.

In the case of State v. Hunsicker, Mr. Hunsicker was state treasurer. His term of office had expired. The books of his office were not posted, and, after the state had expended a large sum of money to have them audited and properly posted, a suit followed for the reimbursement of that sum. This court sustained an exception of no cause of action for the expense incurred in auditing defendant's books, but overruled the exception as to the sum expended for posting the books. While this case may be authority for the proposition that a public official may be sued directly by one who suffers loss through his neglect of duty, it is not authority for the proposition that depositors in a bank may seek personal judgments against the directors of a bank for losses resulting from their negligent management of the bank's affairs.

As the directors are the agents of the bank, they are not responsible to third persons for mere negligence of duty or nonfeasance toward their principal. * * *

We also quote the following from 7 Corpus Juris, p. 565:

"The directors of a bank are liable only to the corporation whose agents they are for violation or negligence of duty; and in the absence of actionable deceit, they are not liable to a creditor of the corporation for loss suffered through the neglect of their official duties."

The judgment appealed from is correct, and it is therefore affirmed, at appellants' cost.

PEPPER v. LITTON.

Supreme Court of the United States, 1939. 308 U.S. 295, 60 S.Ct. 238.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

Proceeding in the matter of Dixie Splint Coal Company, bankrupt, wherein Scott Litton filed a claim which was opposed by Jean McNeil Pepper. A judgment of the District Court disallowing the claim was reversed by the Circuit Court of Appeals, 100 F.2d 830, and Jean McNeil Pepper brings certiorari.

Judgment of Circuit Court of Appeals reversed, and judgment of District Court affirmed.

MR. JUSTICE DOUGLAS, delivered the opinion of the Court. * * * The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it pari passu treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence. A director is a fiduciary. Twin-Lick Oil Company v. Marbury, 91 U.S. 587, 588, 23 L.Ed. 328. So is a dominant or controlling stockholder or group of stockholders. Southern Pacific Company v. Bogert, 250 U.S. 483, 492, 39 S.Ct. 533, 537, 63 L.Ed. 1099. Their powers are powers in trust. See Jackson v. Ludeling, 21 Wall. 616, 624, 22 L.Ed. 492. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. Geddes v. Anaconda Copper Mining Company, 254 U.S. 590, 599, 41 S.Ct. 209, 212, 65 L.Ed. 425. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside. While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.

As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy. In the exercise of its equita-

ble jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder. That is clearly the power and duty of the bankruptcy courts under the reorganization sections. In Taylor v. Standard Gas & Electric Co., 306 U.S. 307, 59 S.Ct. 543, 83 L.Ed. 669, this Court held that the claim of Standard against its subsidiary (admittedly a claim due and owing) should be allowed to participate in the reorganization plan of the subsidiary only in subordination to the preferred stock of the subsidiary. This was based on the equities of the case—the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors. Similar results have properly been reached in ordinary bankruptcy proceedings. Thus, salary claims of officers, directors, and stockholders in the bankruptcy of "one-man" or family corporations have been disallowed or subordinated where the courts have been satisfied that allowance of the claims would not be fair or equitable to other creditors. And that result may be reached even though the salary claim has been reduced to judgment. It is reached where the claim asserted is void or voidable because the vote of the interested director or stockholder helped bring it into being or where the history of the corporation shows dominancy and exploitation on the part of the claimant. It is also reached where on the facts the bankrupt has been used merely as a corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own. And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan.

Though disallowance of such claims will be ordered where they are fictitious or a sham, these cases do not turn on the existence or non-existence of the debt. Rather they involve simply the question of order of payment. At times equity has ordered disallowance or subordination by disregarding the corporate entity. That is to say, it has treated the debtor-corporation simply as a part of the stockholder's own enterprise, consistently with the course of conduct of the stockholder. But in that situation as well as in the others to which we have referred, a sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device

avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandisement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

On such a test the action of the District Court in disallowing or subordinating Litton's claim was clearly correct. Litton allowed his salary claims to lie dormant for years and sought to enforce them only when his debtor corporation was in financial difficulty. Then he used them so that the rights of another creditor were impaired. Litton as an insider utilized his strategic position for his own preferment to the damage of Pepper. Litton as the dominant influence over Dixie Splint Coal Company used his power not to deal fairly with the creditors of that company but to manipulate its affairs in such a manner that when one of its creditors came to collect her just debt the bulk of the assets had disappeared into another Litton company. Litton, though a fiduciary, was enabled by astute legal manœuvering to acquire most of the assets of the bankrupt not for cash or other consideration of value to creditors but for bookkeeping entries representing at best merely Litton's appraisal of the worth of Litton's services over the years.

This alone would be a sufficient basis for the exercise by the District Court of its equitable powers in disallowing the Litton claim. But when there is added the existence of a "planned and fraudulent scheme", as found by the District Court, the necessity of equitable relief against that fraud becomes insistent. No matter how technically legal each step in that scheme may have been, once its basic nature was uncovered it was the duty of the bankruptcy court in the exercise of its equity jurisdiction to undo it. Otherwise, the fiduciary duties of dominant or management stockholders would go for naught; exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart.

The fact that Litton perfected his lien more than four months preceding bankruptcy is no obstacle to equitable relief. In the first place, that lien was but a step in a general fraudulent plan which must be viewed in its entirety. The subsequent sale cannot be taken as an isolated step unconnected with the long antecedent events, all designed to defeat creditors. Buffum, Trustee in Bankruptcy v. Peter Barceloux Co., 289 U.S. 227, 232, 233, 53 S.Ct. 539, 541, 77 L.Ed. 1140. In the second place, Litton is seeking approval by the bankruptcy court of his claim. The four months' provision of the bankruptcy act, is certainly not a statutory limitation on equitable defenses arising out

of a breach of fiduciary duties by him who seeks allowance of a claim.

In view of these considerations we do not have occasion to determine the legitimacy of the "one-man" corporation as a bulwark against the claims of creditors.

Accordingly the judgment of the Circuit Court of Appeals is reversed and that of the District Court is affirmed.

Reversed.

5. NON-TITULAR MANAGEMENT: "THE DOMINANT STOCKHOLDER"

CENTRAL TRUST CO. OF NEW YORK v. BRIDGES.

Circuit Court of Appeals of the United States, 1893. 57 F. 753, 766.

TAFT, CIRCUIT JUDGE: * * * We are clearly of the opinion, therefore, that the contract of August, 1887, whenever executed, correctly represents Eager's actual relation to the company in constructing its road. The contract was one out of which Eager hoped to make profit for himself. It is said that it is one of those contracts frequently condemned by the supreme court. This is true; but the vice of such contracts is not that they do not represent the real relation between the parties, but that they are contracts made by a corporation with one who exercises such an undue influence over the directors, by reason of his relation to them as principal stockholder or otherwise, that it is inequitable and unconscionable for him by such influence to secure individual profit to himself at the expense of the corporation and its other stockholders and bond holders. On this ground, the other stockholders or the bond holders or the corporation itself may call upon a court of equity to set aside the contract against the other party, but no third person can deny its legal existence so long as those who are parties to it do not object to it. It is manifestly absurd to say that the petitioners who supposed they were dealing with Eager as an individual were injured by a contract made by him with the company for his personal benefit and profit, on the ground that he unduly used his influence with the directors of the company to secure this advantage to himself. As they were not injured by it, they cannot complain of it. * * *

FARMERS' LOAN & TRUST CO. v. NEW YORK & N. RY. CO.

Court of Appeals of New York, 1896.
150 N.Y. 410, 44 N.E. 1043, 34 L.R.A. 76, 55 Am.St.Rep. 689.

[The statement of facts is omitted.]

MARTIN, J. That the New York Central & Hudson River Railroad Company purchased a majority of the second mortgage bonds and a majority of the stock of the New York & Northern Railway Company, for the sole purpose of obtaining control of the property of the latter, is clearly established by the proof contained in the record. Indeed, such was the avowed purpose of its purchase. The record renders it equally clear that the New York Central & Hudson River Railroad Company was the actual and beneficial owner of such bonds and stock for several months before the commencement of this action.

They were retained in the hands of Drexel, Morgan & Co., not as owners or holders in their own right, but as agents or naked trustees for the New York Central & Hudson River Railroad, and were clearly subject to the order and control of the latter. Moreover, the request that Drexel, Morgan & Co. made to the plaintiff to commence this action was not only based upon the bonds owned by the New York Central & Hudson River Railroad Company and others it had contracted to purchase, but the sole purpose of that request was to procure a foreclosure, and thus enable the New York Central & Hudson River Railroad Company to acquire control of the property and franchises of the New York & Northern Railway Company for its own benefit, as set forth in the circular letter sent to the stockholders of the New York Central & Hudson River Railroad Company. The president of the latter company himself testified that that was the object and purpose which induced the sending of the notice requesting the commencement of this action. The notice given by the New York Central & Hudson River Railroad Company to its stockholders states the fact that on March 18, 1893, agreements had already been made in respect to the purchase of a controlling interest in the New York & Northern Railway Company, subject to the approval therein asked for. The letter of Drexel, Morgan & Co. to the treasurer of the New York Central & Hudson River Railroad Company, dated April 5, 1893, shows that the majority of the stock and bonds mentioned therein was held by them, subject to the order of the New York Central & Hudson River Railroad Company, and that they had received the note of that company in payment therefor. Thus, it is obvious that this action was procured to be commenced by the New York Central & Hudson River Railroad Company, while it owned a majority of the stock and bonds of the New York & Northern Railway Company, for the sole and avowed purpose of obtaining control of its property and business, regardless of the rights of the minority stockholders or the owners of the remainder of the bonds. The appellants contend that the New York Central & Hudson River Railroad Company, as such majority stockholder, also acquired the entire control of the affairs of the New York & Northern Railway Company through its board of directors, who were willing to serve the interests of those owning a majority of the stock, as was indicated by the resignation of three of the directors, the appointment of others in their places, by the resignation of two officers who occupied important positions in the affairs of that company, and by the appointment of two officers in their places who were in the employ of the New York Central & Hudson River Railroad Company, to discharge the duties of such officers, and compensated for their services by the New York Central & Hudson River Railroad Company. While the proof upon that question was not perhaps conclusive, yet the circumstances developed by the evidence plainly indicate that, after it became the owner of a majority of the stock and bonds, the New York Central & Hudson River Railroad Company dictated and governed the action of the board of directors, and controlled the management of the affairs, of the New York & Northern Railway Company.

The facts already referred to are strong proof that the New York Central & Hudson River Railroad Company was in the control of the

affairs of the New York & Northern Railway Company. It is hardly to be supposed that a board of directors which was not under the control of another corporation would appoint three of the friends of the president of that corporation as directors of the company, and place the officers of that company in control of its financial affairs, especially when it was the owner of competing lines of railroad. The clear and legitimate inference to be drawn from the circumstances proved in this case is that, after the New York Central & Hudson River Railroad Company purchased a majority of the stock and bonds of the New York & Northern Railway Company, it controlled its officers and directors as fully and completely as though they had been elected by its votes. All the facts and circumstances, so far as the defendants were permitted to prove them, tend to show that such was the situation. Indeed, it is a matter of common knowledge that, where the ownership of a majority of the stock of such corporation changes, the board usually changes, unless its members are already in harmony with the policy of the purchasers.

On the trial, the appellants sought to prove that after the New York Central & Hudson River Railroad Company became the owner of such stock and bonds, and while its officers were in substantial control of the New York & Northern Railway Company, they declined to accept traffic from other roads that would have produced a fund with which to pay the interest due on the bonds in question; that the income of the road which should have been employed to pay such interest was used for other and improper purposes; and that such action caused the inability of the New York & Northern Railway Company to pay the interest, and thus cure its default. This evidence was rejected as immaterial, and the appellants duly excepted.

In determining the correctness of the rulings made by the trial court, it becomes necessary to determine incidentally whether a corporation, purchasing a majority of the stock of another competing corporation, may thus obtain control of its affairs, cause it to divert the income from its business, or to refuse business which would enable it to pay the interest for which it was in default, and then institute an action in equity to enforce its obligations, for the purpose of obtaining control of its property at less than its value, to the injury of the minority stockholders, and they have no remedy; or, in other words, whether a court of equity, with those facts established, would lend its aid to such a stockholder, by enforcing the mortgage and decreeing a foreclosure and sale of the mortgaged premises, at its request, in its behalf, and to accomplish such a purpose. If it would, then the rulings of the trial court were proper; if not, then the appellants were entitled to prove those facts, and it was error to reject the evidence.

In Gamble v. Water Co., 123 N.Y. 91, 25 N.E. 201, in discussing a similar question, Judge Peckham, in effect, said that, although it is not every question of mere administration or of policy upon which there might be a difference of opinion that would justify the minority in coming into a court of equity to obtain relief, yet, where the action of a majority of the stockholders of a corporation is fraudulent or oppressive to the minority shareholders, an action may be maintained by the latter, where the contemplated action of the majority is so far op-

posed to the interests of the corporation as to lead to a clear inference that such action is with an intent to serve some outside purpose, regardless of the consequences to the company and inconsistent with its interests.

In Pondir v. Railroad Co., 72 Hun, 385, 389, 25 N.Y.S. 560, where the Erie Railroad Company, through the action of the Buffalo, Bradford & Pittsburgh Railroad Company, whose directors were elected and controlled by the Erie Company, without consideration, obtained the property of the latter corporation, and so arranged its affairs as to render all the shares of its stock, other than those held by the Erie Company, valueless, it was held that a stockholder of the Buffalo, Bradford & Pittsburgh Railroad Company might maintain an action to redress the wrong done to his company. In that case Mr. Justice Follett said: "This was a fraud on the Buffalo, Bradford & Pittsburgh Railroad Company and its shareholders. Such frauds are not uncommon in the management of corporations, and, when they are exposed, should be condemned by the courts, and a heavy hand laid upon all who participate in them."

In Barr v. Railroad Co., 96 N.Y. 444, where the officers of another corporation had leased the property of the first corporation, controlled a majority of its stock, and conspired to compel the minority to sell its stock by refusing to pay the rent due, it was held that a court of equity, on the application of the minority, would compel the payment of the rent; and that, where the majority of the stockholders of a corporation are illegally pursuing a course which is in violation of the rights of the other stockholders, an action to obtain equitable relief may be maintained by an aggrieved stockholder.

Sage v. Culver, 147 N.Y. 241, 41 N.E. 513, is to the effect that, when it can be fairly gathered that the officers and directors of a corporation have made use of relations of trust and confidence to secure or promote some selfish interest, it is enough to set a court of equity in motion, and to require them to explain such a transaction which there is a presumption against in equity.

In Meyer v. Railway Co., 7 N.Y.St.Rep. 245, it was held, that a majority of the stockholders of a corporation would not be permitted to sanction a transaction which is the outcome of a scheme, dishonest or fraudulent in its inception, and that the minority stockholders have rights which under such circumstances must be recognized; that the majority may legally control the company's business, but, in assuming such control, they take upon themselves the correlative duty of diligence and good faith; and that they cannot manipulate the company's business in their own interests, to the injury of the minority stockholders.

In Ervin v. Navigation Co., 27 F. 630, it was held that when a number of stockholders combine to constitute themselves a majority, to control the corporation as they see fit, they become, for all practical purposes, the corporation itself, and assume the trust relation of the corporation towards its stockholders; and if they seek to make profit out of it, at the expense of those whose rights are the same as their own, they are unfaithful to the relation they have assumed, and guilty,

at least, of constructive fraud, which a court of equity will remedy.
* * *

While the question in some of the cases cited arose between stockholders and the directors and officers of a company who, as such, held a position of trust as to the former, still where, as in this case, a majority of the stock is owned by a corporation or a combination of individuals, and it assumes the control of another company's business and affairs through its control of the officers and directors of the corporation, it would seem that for all practical purposes, it becomes the corporation of which it holds a majority of stock, and assumes the same trust relation towards the minority stockholders that a corporation itself usually bears to its stockholders, and therefore, under such circumstances, the rule stated in the Sage Case and other similar cases applies to majority stockholders who control the affairs of the company, as well as to its directors or officers.

It is a controlling maxim that a court of equity will not aid parties in the perpetration or consummation of a fraud, nor give any assistance whereby either of the parties connected with the betrayal of a trust can derive any advantage therefrom. Farley v. Railway Co., 4 McCrary, 138, 14 Fed. 114. "It is a sound principle that he who prevents a thing being done shall not avail himself of the nonperformance he has occasioned." Fleming v. Gilbert, 3 Johns. 528, 531; U.S. v. Peck, 102 U.S. 64; Dolan v. Rodgers, 149 N.Y. 491, 44 N.E. 167.

The principle of these authorities renders it quite obvious that a corporation, purchasing a majority of the stock of another competing one, cannot obtain control of its affairs, divert the income of its business, refuse business which would enable the defaulting company to pay its interest, and then institute an action in equity to enforce its obligations, for the avowed purpose of obtaining entire control of its property, to the injury of the minority stockholders. Such a course of action is clearly opposed to the true interests of the corporation itself, and plainly discloses that one thus acting was not influenced by any honest desire to secure such interests, but that its action was to serve an outside purpose, regardless of consequences to the debtor company, and in a manner inconsistent with its interest and the interest of its minority stockholders.

The respondents, however, contend that the doctrine of the authorities cited is not controlling in this case, but that the New York Central & Hudson River Railroad Company had a right to purchase a majority of the stock and bonds of the New York & Northern Railway Company, for the express purpose of obtaining control of the affairs of the latter for its own use and benefit, and to thus acquire its property at less than its actual value, to the injury of the minority stockholders; and that such stockholders had no remedy, in law or in equity, to protect themselves against such action of the majority stockholders, although it diverted the income which should have been applied to the payment of such interest to other and improper purposes, and refused business which would have enabled the defaulting company to pay its interest. In other words, the claim of the respondents is, and the General Term in effect held, that the purpose for which the New York Central & Hudson River Railroad Company obtained a ma-

jority of the stock and bonds of the New York & Northern Railway Company is entirely immaterial, and that, notwithstanding the existence of such a purpose, a court of equity will aid them in enforcing the mortgage. * * *

That any person or corporation authorized to do so might have purchased the bonds of the New York & Northern Railway Company, and have rigorously enforced them by a sale of its property, there can be no doubt. They might also have purchased the stock of the company, and thus have become the owners of both, and, while such owners, might have enforced the liability of the company upon its bonds, so long as they acted in good faith and their purpose was proper. But when the New York Central & Hudson River Railroad Company purchased the stock and bonds in question, thus obtaining a controlling interest in the affairs of the New York & Northern Railway Company, for the avowed purpose of destroying it, to serve a purpose entirely outside of that for which it was organized, and in hostility to it, it becomes clear that, as such stockholder, it owed a duty to the minority stockholders, that the law implied a quasi trust upon its part, and that a court of equity will not aid it in the destruction of that corporation, and a confiscation of its property, although it held a majority of its stock and the required amount of its bonds.

Hence we are of the opinion that the court erred in rejecting, as immaterial, evidence offered by the appellants to show that after the New York Central & Hudson River Railroad Company became the owner of a majority of the stock and bonds of the New York & Northern Railway Company, and while its officers were in control of the latter corporation and its affairs, it declined to accept traffic from other roads, which would have produced a fund with which to pay the interest that was due; that the income of the road, which should have been employed to pay such interest, was used for other and improper purposes; and that such action upon the part of the majority stockholder occasioned the inability of the company to pay the interest and cure the default. To the rejection of this evidence the defendants excepted. We think many of these rulings were erroneous, and that the appellants had the right to make the proof offered, so far as it related to the transaction of the business of the New York & Northern Railway Company during the time the New York Central & Hudson River Railroad Company owned a majority of its stock, and controlled its affairs; and for the error in those rulings the judgment should be reversed. * * *

JONES v. MISSOURI EDISON ELECTRIC COMPANY et al.

Circuit Court of Appeals of the United States, Eighth Circuit, 1906. 144 F. 765, 771.

A majority of the holders of stock owe to the minority the duty to exercise good faith, care, and diligence to make the property of the corporation in their charge produce the largest possible amount, to protect the interests of the holders of the minority of the stock and to secure and deliver to them their just proportion of the income and of the proceeds of the property. Any sale of the corporate property

to themselves, any disposition by them of the corporation or of its property to deprive the minority holders of their just share of it or to get gain for themselves at the expense of the holders of the minority of the stock, becomes a breach of duty and of trust which invokes plenary relief from a court of chancery.

LEBOLD et al. v. INLAND STEEL COMPANY.

Circuit Court of Appeals of the United States, Seventh Circuit, 1941. 125 F.2d 369.

Action by Foreman M. Lebold and another, minority stockholders of the Inland Steamship Company, aginst the Inland Steel Company, to recover damages for fraud in dissolving the steamship company, buying its assets, and appropriating its business. From a judgment of dismissal, plaintiffs appeal.

Reversed.

LINDLEY, DISTRICT JUDGE. Plaintiffs, minority stockholders of the Inland Steamship Company, brought suit in the District Court to recover damages claimed to have been incurred by them by reason of alleged fraudulent acts of defendant Inland Steel Company in dissolving the Steamship Company, buying its assets and appropriating its business. The theory of plaintiffs was that defendant, owning some 80 per cent of the stock of the Steamship Company, had so utilized its dominant position as majority stockholder as to force the latter company out of a prosperous going business, to bring about its dissolution and to take over its property and its business to the detriment of plaintiffs. The court dismissed the complaint and this appeal followed.

The events preceding the dissolution and sale were before us in Lebold v. Inland Steamship Co., 7 Cir., 82 F.2d 351. There a bill to enjoin dissolution had been dismissed by the District Court. Upon appeal we held the complaint premature and affirmed the dismissal, without prejudice however, to the right of plaintiffs to apply for relief if developments thereafter, coupled with what had already happened, should justify such action. Neither the facts there involved nor the law there announced need repetition.

In addition to the facts presented in that record, we have here evidence of events subsequent to that decision. Throughout the duration of the litigation involved in the prior decision, the business of the Steamship Company continued without interruption or change. The operations for the year 1935, which were not in the prior record, were successful, as had been those of all earlier years, and on December 19, 1935 the directors authorized an annual dividend of $150 per share. The decision was announced on March 18, 1936. Eight days thereafter, notice of a special meeting of stockholders was given, to be held April 2, 1936, for the purpose of dissolution. Mr. P. D. Block, president of the Steamship Company and of the Steel Company presided. Others present were L. E. Block, a director of both corporations, Randall, vice president, director and manager of the transportation business of the Steamship Company and also vice president and director of the Steel Company, E. L. Ryerson, Jr., director of both companies, Morris, employee of the Steel Company and secretary of the Steamship

Company, Truesdale of the Steel Company and Mullen and plaintiffs, minority stockholders, and counsel for the Inland Steel Company. Over the negative vote of the minority stockholders, a resolution was adopted directing dissolution of the Steamship Company. Block stated that the reason for such action had been submitted before and that he saw no good reason for "rehashing" it. One of plaintiffs asked Randall whether the Steamship Company had been given opportunity to bid for the Steel Company freight traffic or whether, as a director of the Steamship Company, he had made an effort to get the traffic on a competitive basis with other bids received. Randall replied that he had been instructed by President Block that "under no circumstances" did he, Block, wish to transact any business with the Steamship Company. Plaintiffs requested that the minutes reflect the fact that the Steamship Company had been given no opportunity to bid on carrying freight for the Steel Company. Block observed that the meeting was a Steamship Company meeting and not one of the Steel Company and that "they were not obligated to give any information concerning" the latter. Randall went so far as to say that but for his courtesy, he would not have replied to the question. At the trial Randall testified that he had made no effort to secure traffic for the Steamship Company from any sources other than from the Steel Company because that company had kept the Steamship Company's boats busy during 1934 and 1935. He said further that when he became "certain of dissolution," he made no effort to get traffic for the Steamship Company on the theory that it might be able to continue in business. Later a directors' meeting was held on April 14, 1936, attended by the Blocks, Randall and Foreman Lebold. The latter did not vote. The directors authorized a sale of all assets on May 1. At that time the Steel Company bid in the three boats owned by the Steamship Company at $1,120,000, apparently their fair value. There were no other bidders. Defendant immediately took over the boats. It continued the transportation business formerly conducted by the Steamship Company and has carried it on without interruption or change, continuously, ever since.

The master found that plaintiffs were entitled only to their pro rata share of the proceeds of sale of the boats. The court agreed and dismissal followed. Plaintiffs insist that the District Court failed to apprehend the purport of and give effect to this court's decision and to draw from the facts in the record proper legal conclusions.

At the outset, giving consideration to the facts involved in the former proceeding and those presented for the first time, it is well to keep in mind that at all of the stockholders' meetings and directors' meetings involved, the majority stockholder, defendant, was in control. Defendant, owning 80 per cent of the stock, had the power to determine and did determine the actions of the Steamship Company. It is perfectly apparent, indeed, the officers of defendant themselves indicate that their interest was to force dissolution so that they might get rid of the minority interest and take over the assets and business of the Steamship Company. It is only with this elementary indisputable premise in mind that the proper answer to the controversy can be reached.

The directors of a corporation represent it and its stockholders; the majority stockholders of a corporation represent it and its minority stockholders. The vote of every director and of every majority stockholder must be directed to and controlled by the guiding question of what is best for the corporation, for which he is, to all legal intents and purposes, trustee. In his voting, in his management, he is bound to be wholeheartedly, earnestly and honestly faithful to his corporation and its best interests; his own selfish interests must be ignored. If when he votes he does so against the interest of his company, against the interest of his minority and in favor of his own interest, by such selfish action, by omission of fidelity to his own duty as a trustee, he forfeits approval in a court of equity. When the Blocks and Randall voted in the Steamship Company meeting they were within their statutory right to force a dissolution, but no legislative enactment could endow them with the right as trustees for the minority stockholders to take over for their own, through any legal device, plan or method all assets and all business of the company for which they were fiduciaries, if to do so was clearly and obviously against the best interests of the company and the minority stockholders. Obviously and admittedly these gentlemen were not thinking of the Steamship Company's interest; they were wholly ignoring it. Their sole interest lay in the Steel Company and, in the words of Randall, it "griped them to see that the minority stockholders were enjoying any profit." Therefore, we must accept the obvious fact, namely, that defendant and its officials, failing to perform their duties as stockholders and directors of the Steamship Company, were faithless to that company and to the minority stockholders. The latter were powerless to help themselves; they rightfully complain of the breach of trust upon the part of defendant resulting in damage.

In Pepper v. Litton, 308 U.S. 295 at page 306, 60 S.Ct. 238, 245, 84 L.Ed. 281, Mr. Justice Douglas, discussing the responsibility of directors and of dominant or controlling stockholders, said: "A director is a fiduciary. Twin-Lick Oil Co. v. Marbury, 91 U.S. 587, 588, 23 L.Ed. 328. So is a dominant or controlling stockholder or group of stockholders. Southern Pacific Co. v. Bogert, 250 U.S. 483, 492, 39 S.Ct. 533, 537, 63 L.Ed. 1099. Their powers are powers in trust. See Jackson v. Ludeling, 21 Wall. 616, 624, 22 L.Ed. 492. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599, 41 S.Ct. 209, 212, 65 L.Ed. 425. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. * * * He who is in such a fiduciary position *cannot serve himself first and his cestuis second.* He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. * * * He cannot utilize his inside information

and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandisement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis." Here the strategic position of defendant was used solely for its own preferment; the affairs of the corporation were "manipulated" to plaintiffs' detriment. Here defendant did "indirectly through the corporation what it could not do directly."

Defendant says it has not appropriated the business of the Steamship Company. The statutes of West Virginia, Sec. 80, Chap. 31, Art. 1, W.Va. Code of 1931, which control the dissolution proceedings, authorize the majority to dissolve and "discontinue the business of the corporation." Here the business was not discontinued; defendant took over the boats, it continued to operate them, it continued to devote them to the same transportation that they had always carried on. The business which had been prosperous for twenty-five years was turned over to defendant. By its strategic position, by its dominant situation, it could and did force a sale, bid in the property itself and thereafter continue to operate the business as before. The Steamship Company had been organized many years before to transport freight for hire; it had transported only the freight of defendant; this it continues to do, the only difference being that now the latter realizes all the profit which results from such transportation and the minority stockholders get none of it.

This transportation business was in no wise the business of the Steel Company. It was the business carried on by the Steamship Company, a business which the defendant expressly said it was going to put out of existence. In its strategic position of dominance, even though it was trustee for the minority stockholders, defendant warned plaintiffs that if they did not sell their stock, the Steel Company would end all business relations with the Steamship Company and that they must either sell their stock or see the Steamship Company go out of business. That these threats were not idle, that they were made with the ulterior motive, to bring duress to bear and to force plaintiffs, is now obvious. The business was never interrupted, never curtailed, never modified but continued without interruption.

What defendant might have accomplished under color of the West Virginia statute was discontinuance of the business. What it did, was to take, through form of a sale, the physical assets and the entire business of the Steamship Company. Whether we stamp the happenings as dissolution or with some other name, equity looks to the essential character and result to determine whether there has been faithlessness and fraud upon the part of the fiduciary. However proper a plan may be legally, a majority stockholder can not, under its color, appropriate a business belonging to a corporation to the detriment of the minority stockholder. The so called dissolution was a mere device

by means of which defendant appropriated for itself the transportation business of the Steamship Company to the detriment of plaintiffs. That the source of this power is found in a statute, supplies no reason for clothing it with a superior sanctity, or vesting it with the attributes of tyranny. Allied Chemical & Dye Corp. v. Steel & Tube Co. of America, 14 Del. 1, 120 A. 486. The books are full of instances of disapproval of such action. If it be an absorption by the dominant member of all the returns of the corporate investment, or a sale of the property to oneself for an inadequate consideration, or deprivation by a syndicate formed to freeze out a minority stockholder through sale and dissolution or if the buyer and seller are the same, the right of a stockholder to vote becomes a power in trust when he owns the majority and assumes and exercises domination and control over corporate affairs. Such majority stockholders' vote "must not be so antagonistic to the corporation as a whole as to indicate that their interests are wholly outside of the interest of the corporation and destructive of the interests of the minority shareholders." * * *

Furthermore it seems to us that defendant may not be permitted to say that there were no values other than those of physical assets. By taking over the assets and by continuing the prosperous business of its former cestui que trust defendant has removed itself from the place where it is permissible for it to contend that there is no prosperous business. That there was value over and above physical assets is perfectly obvious from the fact that a prosperous business existed and is still being conducted; that plaintiffs, if they had not been deprived to their interest, would be still sharing in the returns from that business and that at the present time all the profits of such are being enjoyed by defendant to the total exclusion of plaintiffs.

It follows that the true rule for determination of the value of plaintiffs' interest must be based upon the value not of the physical assets alone but upon all the elements mentioned in our former opinion and in arriving at such value, all those elements, including value as a going concern, must be taken into consideration. In twenty-five years the business of the Steamship Company has never ceased to be a going concern. It has been extremely prosperous. It continues to be so without threat of interruption. In this going concern plaintiffs had an interest. * * * The master found that defendant had not appropriated anything belonging to plaintiffs as minority stockholders and that the value of such minority interests did not exceed their pro rata shares of the proceeds of sale of the ships. The court approved this finding.

* * * It appears from both plaintiffs' and defendant's testimony that if the Steamship Company had been considered a going concern and if its business might reasonably be expected to continue, the value of plaintiffs' stock would be in the neighborhood of $2000 per share.

That the master was misled in his reasoning is apparent from some of his findings. He said "the permitted participation in handsome returns for twenty-five years seems to me a very reasonable limitation for the duration of any such obligation." Obviously this is fallacious. It is not a question of how much profit plaintiffs and defendant have previously enjoyed from ownership of stock in the Steamship Com-

pany, but a question of what the existence of the transportation business of that company, which defendant has wrongfully taken, is now fairly worth. Henry Ford could not rightfully say to one of the stockholders who invested in the Ford automobile company in its beginning and whose investment had multiplied thousands of times in value, that in view of the handsome returns he had had upon the investment, he must deliver the stock to Mr. Ford upon receipt of his pro rata share of the value of the physical assets of the Ford Company or Mr. Ford would dissolve the company and bid in the assets and deprive him of any such returns.

After the sale of the physical assets, the proceeds were divided amongst the stockholders of the Steamship Company, each receiving his proportionate share. These were treated as liquidating dividends and as such plaintiffs receipted for them. Defendant now contends that by acceptance of the distributive share of the proceeds of sale of the boats, plaintiffs are estopped to prosecute the present suit.

No estoppel arises upon these facts. Plaintiffs are suing, not to rescind the sale, but to recover a money judgment, alleged to be due them because of their damage incurred by the fraud of defendant. This demand is for something over and above and in addition to plaintiffs' proportionate share of the proceeds of liquidation of physical assets. Estoppel arises only when one has so acted as to mislead another and the one thus misled has relied upon the action of the inducing party to his prejudice. * * *

Plaintiffs did not remain silent. They brought their suit prematurely and this court affirmed its dismissal because of such prematurity, expressly stating, however, that the dismissal should be without prejudice to plaintiffs to complain if future developments should justify their fears. Defendant had the right under the statute of the state in which the Steamship Company was incorporated to work a dissolution. Following that it was bound to distribute the proceeds realized pro rata amongst the stockholders, but the receipt of such share in no wise affected the complaint of plaintiffs not that the sale should be rescinded but that in prosecuting the legal procedure of dissolution defendant had over-reached plaintiffs and damaged them. Their demand for damages was not involved at all in their receipt of the pro rata shares of the proceeds of sale of the Steamship Company's boats. Plaintiffs did not acquiesce in or consent to perpetration of a fraud against them. Defendant has not been misled; it has not relied, to its injury or prejudice, upon any acquiescence or inducement on the part of plaintiffs.

Upon the record defendant is liable to plaintiffs. The damages to be allowed are the difference between what plaintiffs have received from the sale of the physical assets and what the stock was really worth as stock in a going prosperous concern continuing in business. Upon that rule the trial court will fix plaintiffs' damages.

The judgment is reversed for action by the District Court consistent with this opinion.

THE SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C.A. § 78(p)

DIRECTORS, OFFICERS, AND PRINCIPAL STOCKHOLDERS

Sec. 16. (a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

(c) It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer (other than an exempted security), if the person selling the security or his principal (1) does not own the security sold, or (2) if owning the security, does not deliver it against such sale within twenty days thereafter, or does not within five days after such sale deposit it in the mails or other usual channels of transportation; but no person shall be deemed to have violated this subsection if he proves

that notwithstanding the exercise of good faith he was unable to make such delivery or deposit within such time, or that to do so would cause undue inconvenience or expense.

(d) The provisions of this section shall not apply to foreign or domestic arbitrage transactions unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes of this section.

6. ARE THERE WIDER RESPONSIBILITIES

NOTE

(A) The view that those who manage our business corporations should concern themselves with the interests of employees, consumers, and the general public, as well as of the stockholders, is thus advanced today by persons whose position in the business world is such as to give them great power of influencing both business opinion and public opinion generally. Little or no attempt seems to have been made, however, to consider how far such an attitude on the part of corporate managers is compatible with the legal duties which they owe the stockholder-owners as the elected representatives of the latter.

No doubt it is to a large extent true that an attempt by business managers to take into consideration the welfare of employees and consumers (and under modern industrial conditions the two classes are largely the same) will in the long run increase the profits of stockholders. As Dean Donham and others have demonstrated, it is the lack of a feeling of security on the part of those who are dependent on employment for their livelihood which is largely responsible for the present under-consumption which has so disastrous an effect upon business profits. If the social responsibility of business means merely a more enlightened view as to the ultimate advantage of the stockholder-owners, then obviously corporate managers may accept such social responsibility without any departure from the traditional view that their function is to seek to obtain the maximum amount of profits for their stockholders.

And yet one need not be unduly credulous to feel that there is more to this talk of social responsibility on the part of corporation managers than merely a more intelligent appreciation of what tends to the ultimate benefit of their stockholders. Modern large-scale industry has given to the managers of our principal corporations enormous power over the welfare of wage earners and consumers, particularly the former. Power over the lives of others tends to create on the part of those most worthy to exercise it a sense of responsibility. The managers, who along with the subordinate employees are part of the group which is contributing to the success of the enterprise by day-to-day efforts, may easily come to feel as strong a community of interest with their fellow workers as with a group of investors whose only connection with the enterprise is that they or their predecessors in title invested money in it, perhaps in the rather remote past.[34]

[34] Some of our most successful industrial corporations have for years obtained all the additional capital which they needed out of surplus profits without any further issue of securities. See, e. g., The General Electric Co., Moody's Manual of In-

Moreover, the concept that the managers are merely, in Mr. Young's phrase, "attorneys for the investors" leads to the conclusion that if other classes who are affected by the corporation's activities need protection, that protection must be entrusted to other hands than those of the managers. Desire to retain their present powers accordingly encourages the latter to adopt and disseminate the view that they are guardians of all the interests which the corporation affects and not merely servants of its absentee owners.

Any clash between this point of view and the orthodox theory that the managers are elected by stockholder-owners to serve their interests exclusively has thus far been chiefly potential rather than actual. Judicial willingness—which has increased of late—to allow corporate directors a wide range of discretion as to what policies will best promote the interests of the stockholders, together with managerial disinclination to indulge a sense of social responsibility to a point where it is likely to injure the stockholders, has thus far prevented the issue from being frequently raised in clear-cut fashion in litigation.[35]

Nevertheless there are indications that even today corporation managers not infrequently use corporate funds in ways which suggest a social responsibility rather than an exclusively profit-making viewpoint. * * * The view that directors may within limits properly use corporate funds to support charities which are important to the welfare of the community in which the corporation does business probably comes much nearer representing the attitude of public opinion and the present corporate practice than does the traditional language of courts and lawyers. Nor are there wanting signs of the adoption of a more liberal attitude by legislatures [36] and judges.[37]

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vestments, Industrial Securities (1931) 971, indicating that the only outstanding bonds of that corporation were issued in 1902 and that no stock has been issued since 1920 except as a stock dividend or split-up.

35 It was raised in the case of Dodge v. Ford Motor Co., * * * in which Mr. Ford's expressions of an intention to share profits with the public through a reduction in prices were relied upon as justifying a decree compelling the declaration of a dividend out of the large surplus of the company. Neither the language of the opinion nor the relief granted necessarily involves an unqualified acceptance of the maximum-profit-for-stockholders formula. The opinion states that "a business corporation is organized and carried on primarily for the profit of the stockholders" and that directors cannot lawfully "conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others." 204 Mich. at 507, 170 N.W. at 684. Despite testimony of Mr. Ford that he planned to expand the enterprise in the interest of consumers rather than of stockholders, the court was careful so to limit its decree as not to interfere seriously with the expansion program. Its avowed reason for so doing was that expansion might be made profitable despite Mr. Ford's expressed indifference to profit. One may suspect that it was also motivated, consciously or unconsciously, by a reluctance to prevent the growth of a socially important enterprise.

36 Cf. Tex.Acts 1917, c. 15, §§ 1, 3; construed in James McCord Co. v. Citizens' Hotel Co., 287 S.W. 906 (Tex.Civ.App.1926); N.Y.Laws 1931, Supp. c. 24, § 33.

37 Again, we see no reason why if a railroad company desires to foster, encourage and contribute to a charitable enterprise, or to one designed for the public weal and welfare, it may not do so. Maitland, in "Collected Essays," says: "If the law allows men to form permanently organized groups, those groups will be, for common opinion, right-and-duty bearing units; and if the lawgiver will not openly treat them as such he will misrepresent, or, as the French say, he will 'denature' the facts: in other words, he will make a mess and call it law." We see no reason why a railroad corporation may not, to a reasonable extent, donate funds or services to aid in good works. Per Letton, J., in State ex rel. Sorensen v. Chicago, B. & Q. R. R., 112 Neb. 248, 255–56, 199 N.W. 534, 537 (1924).

Such a view is difficult to justify if we insist on thinking of the business corporation as merely an aggregate of stockholders with directors and officers chosen by them as their trustees or agents. It is not for a trustee to be public-spirited with his beneficiary's property. But we are not bound to treat the corporation as a mere aggregate of stockholders. The traditional view of our law is that a corporation is a distinct legal entity. Unfortunately, its entity character has been thought of as something conferred upon it by the state which, by a mysterious rite called incorporation, magically produces *"e pluribus unum."* The present vogue of legal realism breeds dissatisfaction with such legal mysteries and leads to insistence on viewing the corporation as it really is. So viewing it we may, as many do, insist that it is a mere aggregate of stockholders; but there is another way of regarding it which has distinguished adherents. According to this concept any organized group, particularly if its organization is of a permanent character, is a factual unit, "a body which from no fiction of law but from the very nature of things differs from the individuals of whom it is constituted." [38] * * *

* * * A sense of social responsibility toward employees, consumers, and the general public may thus come to be regarded as the appropriate attitude to be adopted by those who are engaged in business, with the result that those who own their own businesses and are free to do what they like may increasingly adopt such an attitude. Business ethics may thus tend to become in some degree those of a profession rather than of a trade.

Such a development of business ethics which goes beyond the requirements of law and beyond the dictates of enlightened self-interest is impossible in these days when most business is incorporated unless it can touch incorporated business enterprises as well as those conducted by individual owners. As a practical matter, this can happen only if the managers of such corporations have some degree of legal freedom to act upon such an attitude without waiting for the unanimous consent of the stockholders. That the duty of the managers is to employ the funds of the corporate institution which they manage solely for the purposes of their institution is indisputable. That that purpose, both factually and legally, is maximum stockholder profit has commonly been assumed by lawyers. That such is factually the purpose of the stockholders in creating the association may be granted. Nevertheless, the association, once it becomes a going concern, takes its place in a business world with certain ethical standards which appear to be developing in the direction of increased social responsibility. If we think of it as an institution which differs in the nature of things from the individuals who compose it, we may then readily conceive of it as a person, which, like other persons engaged in business, is affected not only by the laws which regulate business but by the attitude of public and business opinion as to the social obligations of business. If business is tending to become a profession, then a corporate person

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[38] Dicey, Law and Public Opinion in England (3d ed. 1920) 165. Cf. Laski, The Personality of Associations (1916) 29 Harv.L.Rev. 404. See also United Mine Workers v. Coronado Coal Co., 259 U.S. 344, 42 S.Ct. 570, (1922); Taff Vale Ry. v. Amalgamated Soc. of Ry. Servants, [1901] A.C. 426.

engaged in business is a professional even though its stockholders, who take no active part in the conduct of the business, may not be. Those through whom it acts may therefore employ its funds in a manner appropriate to a person practising a profession and imbued with a sense of social responsibility without thereby being guilty of a breach of trust. Dodd, For Whom are Corporate Managers Trustees? 45 Harv.L.Rev. 1145, 1156–1161 (1932).

(B) The administration of corporations—peculiarly, a few hundred large corporations—is now the crux of American industrial life. Upon the securities of these corporations has been erected the dominant part of the property system of the industrial east. A major function of these securities is to provide safety, security, or means of support for that part of the community which is unable to earn its living in the normal channels of work or trade. Under cover of that system, certain individuals may perhaps acquire a disproportionate share of wealth. But this is an incident to the system and not its major premise; statistically, it plays a relatively minor part. Historically, and as a matter of law, corporate managements have been required to run their affairs in the interests of their security holders. From time to time other groups, notably labor, have asserted their claims; and these claims are receiving steadily greater recognition as a cost of industry. If these costs are not met, security holders receive an illusory additional profit. But the security holder's claim was the supposed main objective.

Professor Dodd has challenged the theory.[39] * * *

Now I submit that you can not abandon emphasis on "the view that business corporations exist for the sole purpose of making profits for their stockholders" until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else. * * * Nothing is accomplished, either as a matter of law or of economics, merely by saying that the claim of this group ought not to be "emphasized." Either you have a system based on individual ownership of property or you do not. If not—and there are at the moment plenty of reasons why capitalism does not seem ideal—it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control of national wealth and income is so apportioned and enforced that the community as a whole, or at least the great bulk of it, is properly taken care of. Otherwise the economic power now mobilized and massed under the corporate form, in the hands of a few thousand directors, and the few hundred individuals holding "control"[40] is

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39 For Whom are Corporate Managers Trustees? (1932) 45 Harv.L.Rev. 1145.

40 The two hundred largest corporations, comprising somewhere between forty and fifty per cent of the industrial wealth of the country, have altogether slightly more than twenty-eight hundred directors. From this must be subtracted a certain number of inactive representatives of large stockholdings. The "control" of these corporations represented by holders of dominant minorities or by the beneficiaries of devices such as voting trusts, pyramided holding corporations, and the like, analyzes down to a very few men. If in place of two hundred corporations perhaps six hundred and fifty corporations are taken, the result would show approximately sixty-five per cent of the industrial wealth of the country administered by perhaps five thousand directors and perhaps seven or eight hundred individuals holding "control."

simply handed over, weakly, to the present administrators with a pious wish that something nice will come out of it all.

The only thing that can come out of it, in any long view, is the massing of group after group to assert their private claims by force or threat—to take what each can get, just as corporate managements do. The laborer is invited to organize and strike, the security holder is invited either to jettison his corporate securities and demand relief from the state, or to decline to save money at all under a system which grants to someone else power to take his savings at will. The consumer or patron is left nowhere, unless he learns the dubious art of boycott. This is an invitation not to law or orderly government, but to a process of economic civil war. * * *

What ought to be the part of lawyers and the law in this interplay of great hope and disillusioning fact?

Unfortunately, the lawyers have not given too good an account of themselves thus far, either in theory or administration. * * *

Nevertheless, development in the corporate field is more likely to come through lawyers than through any other group. For one thing, they do, approximately, understand the system. They have, however, a function widely divergent from that of the economist or the social theorist. They must meet a series of practical situations from day to day. They are not, accordingly, in a position to relinquish one position—here, the idea of corporate trusteeship for security holdings—leaving the situation in flux until a new order shall emerge. Legal technique does not contemplate intervening periods of chaos; it can only follow out new theories as they become established and accepted by the community at large. It is likely that claims upon corporate wealth and corporate income will be asserted from many directions. The shareholder who now has a primary property right over residual income after expenses are met, may ultimately be conceived of as having an equal participation with a number of other claimants. Or he may emerge, still with a primary property right over residual income, but subordinated to a number of claims by labor, by customers and patrons, by the community and the like, which cut down that residue. It would, as Professor Dodd points out, be unfortunate to leave the law in such shape that these developments could not be recognized as a matter of constitutional or corporation law. But it is one thing to say that the law must allow for such developments. It is quite another to grant uncontrolled power to corporate managers in the hope that they will produce that development. * * * Berle, For Whom Corporate Managers Are Trustees: A Note, 45 Harv.L.Rev. 1365 (1932).

(C) For more than a hundred years we kept up the pretty fiction that each industrial enterprise, no matter how big, was a purely private concern. How the managers handled it was nobody else's business, so long as they kept away from the less conventional forms of fraud. They were supposed to be responsible to the stockholders alone; their operations—in theory—were of no interest to the rest of the community.

This curious fancy survived only because it was tied up with another polite fiction—the pretense that there were hundreds of inde-

pendent little firms in each industry; that competition would keep all of them on their best behavior; and that everything somehow would work out automatically in the public interest.

For a long time now it has been perfectly clear that both of these theories are wildly unreal. Most of the nation's key industries are now dominated by companies which you can count on the fingers of a mutilated hand—for example, three in automobiles (90 per cent), four in steel (64 per cent), four in copper (82 per cent), two in aluminum (more than 90 per cent), and so on through the list. What competition still remains usually is conducted with gentlemanly restraint.

And as everybody knows, the business of such companies no longer is a merely private concern. When the board of U. S. Steel makes a decision on prices—or on wages or its rate of new investment—every citizen of the United States is affected, just as truly as he would be by an act of Congress. Frequently even more. Many laws touch us only lightly; but if any one of the two hundred top corporations starts to jack up prices or to lay off men, that means money out of our pockets. If many of them act together—as they generally do—it may mean lost jobs or short rations for millions of us. When a giant American oil company makes a deal with its British counterpart for the exploitation of the Middle East oil pool, the agreement has all the effects of a treaty. It expresses the national interest in one of the world's most vital resources, and it commits American diplomacy (and ultimately American lives) to defend that interest.

Perhaps it is time, then, for us to recognize the obvious truth: such decisions cannot properly be made in the secrecy of a private board room, by men who bear no direct public responsibility. These are political questions, in the fundamental sense of *res publica;* they are matters of first consequence to the entire body politic. They ought to be debated as openly and fully as any act of Congress; and the men who decide them must somehow be held publicly accountable for their decisions.

This would mean a new status for a relatively few great corporations—the two hundred, more or less, which make up the central switchboard of the nation's economy. It would mean that these companies—less than one per cent of the country's total number—would no longer be regarded as private businesses, but as public institutions. Their management would no longer be responsible to the stockholders alone, but to all the people. Their first duty would become, not simply to earn the biggest possible profit for each individual firm, but to keep the whole economy running smoothly on the tracks.

Such a concept need not involve public ownership. On the contrary, its aim would be to avoid that wholesale nationalization—with all its dangers to freedom, initiative, and efficiency—which is almost certain to engulf us (as it already has engulfed most of the rest of the world) if we collapse into another major depression. Nor would it necessarily mean more interference with business. For some 99 per cent of America's business firms, it might in fact result in considerably less regimentation and direct government supervision.

What it would mean is a new kind of *responsible* capitalism. It would mean a new relationship between the government and the two

hundred strategic corporations, which would leave them under private management *but which would insure that their power to control the nation's economy always would be used in the public interest.*

The idea is by no means new. In Great Britain certain big corporations have long worked so closely with the government (especially in foreign affairs) that it is often difficult to tell just where their private business leaves off and His Majesty's business starts in. The Bank of England, of course, is the classic example. Although its stock was privately held, and paid handsome dividends, the Bank behaved for many years as if it were an arm of the cabinet. It became the main link between the government and the business world, the central mechanism for managing the British economy; its governors thought of themselves as statesmen, whose first responsibility was to the nation rather than to their stockholders. Consequently, when the Bank was finally nationalized a few months ago, the ceremony was purely symbolic—the same gentlemen in striped trousers and black homburgs kept right on doing the same things in precisely the same old way.

In this country too, the idea of responsible corporate behavior already has made some headway. The great oil companies, for instance, normally consult the State Department on the big policy decisions concerning their foreign operations. So do investment bankers engaged in large-scale foreign lending. In the domestic field, a few of the wiser monopolies, such as A T & T and Western Union, conduct their day-today affairs very much as if they were government agencies—presumably on the theory that this is the surest way to stave off public ownership. Recently one or two big companies—notably Ford and International Harvester—have cut prices in the avowed interest of national economic stability, although this action cost them plenty of money and was not forced by either competition or market conditions. Through their Committee for Economic Development a good many business men have made a tacit and rudimentary acknowledgment of their joint responsibility for long-range economic planning, and such leaders as Beardsley Ruml, Henry Kaiser, and Charles Luckman have become forthright spokesmen for a new business philosophy.

So far, however, these are sporadic cases, arising out of the occasional insight of a few uncommonly courageous and far-sighted executives. The problem is to extend this pattern of behavior—to establish it as a consistent habit among all the men who run our strategic concentrations of economic power.

This cannot, of course, be accomplished merely by exhortation. It requires a new relationship between the dominant corporations and society, under which rewards and honors will go to those managers who act as responsible stewards, and penalties will fall upon those who persist in behaving like robber barons. The carrot and the stick are still the only reliable means for keeping the donkey moving down the straight and narrow path.

If liberal political theory develops along these lines—as I think it may—its chief task for the next decade will be to work out the techniques and nuances of this new relationship between government and big business. For a concept of this kind cannot be brought to life simply by passing a law or setting up a new regulatory agency. It will

require many devices, hammered out through a tedious process of trial and error.

Some of the machinery already is at hand. A start might be made, for example, by the President's new Council of Economic Advisers, which seems destined to develop into a sort of economic general staff. As a first step it might well undertake an inquiry into the present structure of American industry, with the purpose of drawing up a master list of the two hundred or so corporations which exercise working direction over the nation's economic life. Its report could set forth —for future guidance—just how each of these strategic firms fits into the intricate mechanism of control, and how it manipulates the lower echelons of business by means of purchasing and marketing agreements, financial connections, patent licensing, interlocking directorates, and similar administrative levers.

On the basis of such a report, the Council could then ask Congress to recognize formally the crucially important role of the Two Hundred, by conferring on them a special status and special responsibilities. Perhaps this could be done most easily by some such scheme as Senator O'Mahoney's plan for federal incorporation. These key companies—and these alone—might be required to operate under federal charters, providing specific guarantees of responsible behavior. They would have to agree, for example, never to use their vast quasi-monopolistic powers to restrict output, extort unjustified prices, or rig cartel agreements with foreign concerns. They would also be required to conduct their affairs in a goldfish bowl, just like any other public institution; and the Economic Council no doubt would need to develop a specially trained staff to keep their records and day-to-day operations under constant scrutiny.

Publicity probably would serve, in normal circumstances, as the only weapon needed to enforce these rules. No executive would care to have the Economic Council announce that he was cooking up a little stock deal for his personal profit, gigging the customers with a price-fixing scheme, bribing a state legislature, flirting with a Swiss cartel, or otherwise disporting himself in a manner unbecoming to a corporation officer and a gentleman. To deal with any recalcitrant survivors of the old public-be-damned school, however, the Council might occasionally have to turn to the courts. It would hardly be worthwhile to impose fines, because our anti-trust experience has shown that they are seldom an effective deterrent to wealthy transgressors. Instead the courts might be empowered to rule that any official who does not live up to his august responsibilities should be barred forever from employment in any of the two hundred key corporations. The social stigma of such a decree might become, in time, almost as fearsome as imprisonment.

The management of the Two Hundred could well be called upon to shoulder certain group responsibilities as well. Their most important decisions, from the standpoint of the national economy, are those concerning the volume of corporate savings (in the form of reserves, depreciation, and undistributed profits) and the rate of new investment. These are the two gyroscopes—as Mr. Keynes has taught us—which largely govern the stability of the economy. When they get out of

kilter, so that savings pile up faster than they can find an outlet in investment, the result is a depression.

Consequently, the Economic Council might call the Two Hundred into consultation each year on their future plans for savings and investment. (After all, these firms directly control something like sixty per cent of the total stream of investment, and indirectly they influence a good deal more. Similarly, their wage, dividend, and price policies largely determine the rate of individual savings and consumer spending.) If it should appear that business investment for the year is likely to fall short of the total necessary to keep the economy rolling, the Council might suggest that they revise their estimates upward. Their incentive to oblige would be strong, because the alternative would be government investment in public works to fill the gap—and that money, in the long run, would mostly come out of business's pocket in taxes.

In like fashion, whenever savings began to stack up at the expense of consumer purchasing power, the Council might recommend price cuts, higher wages, and lower profit margins. No prudent management could ignore such hints; for if it did, responsibility for the ensuing smashup would be inescapably fixed.

Such co-operative planning for economic stability should go a long way toward curing our labor troubles, because it would aim to end that insecurity—that haunting fear of unemployment—which underlies most labor unrest. Moreover, the unions presumably would sit in with government and management in the planning process; and the sharing of responsibility is the surest way of learning responsible behavior.

In a few peculiarly vital industries, however, labor might have to forego its right to strike; and in return it would have to receive a special standing and special privileges comparable to those of the civil service. Railway labor already has something approaching this status. It works under a special law, the Railway Labor Act; it has its own security legislation in the Railroad Retirement Act; its union contracts have established a sort of civil service procedure on promotions and working conditions; and President Truman (with overwhelming public support) recently denied its right to paralyze the nation by striking. In any such industry where strikes are clearly intolerable, labor probably would demand—and should get—one further guarantee before it gives up its strike weapon. Some machinery would have to be set up for the periodic review of wages, so that increases would come automatically with every increase in labor's productivity.

Certainly it would not be easy to make a responsible and directed capitalism of this kind work. It would require, first of all, a new attitude among both our business leaders and our bureaucrats. Government employees would have to quit talking about business men as if they were all public enemies; and industrialists would have to learn that Washington is not populated entirely by crazy college professors and disguised Bolsheviks plotting to wreck The American Way of Life. A certain minimum of good faith and respect on both sides would be

indispensable—plus a mutual willingness to give the scheme a fair trial.

Also necessary would be a thoroughgoing reorganization of the government, to bring some order out of the present demented jungle of overlapping and uncoordinated agencies. Until Washington develops a machinery for producing prompt, consistent policy decisions, it clearly will not be able to give much useful guidance to business men; nor can industrialists be expected to co-operate as long as a dozen different bureaus and commissions are belaboring them with conflicting advice. The creation of a competent and well-paid civil service, capable of attracting really first-rate men, together with a coordinating cabinet secretariat of the sort recently suggested by Joseph and Stewart Alsop, might be a good first step.

Obviously, too, the system would be beset by dangers, as any adventurous undertaking is bound to be. Some extreme leftwingers no doubt would seize upon it as a first step toward a Communist society, while their counterparts of the extreme right might try to convert it into a corporative state. Constant vigilance would be necessary to keep either the government from trying to run the Two Hundred Corporations, or the Two Hundred Corporations from getting ambitions to take over the government. In addition, it would have to be made perfectly clear that the special status of the selected corporations would not imply either an excuse for inefficient management nor a promise of public subsidy.

But these difficulties are not necessarily insuperable—and it is not an American habit to flinch from tough jobs. Any program for handling the impending economic crisis will bristle with dangers and difficulties. They can be avoided entirely only by doing nothing—which is, of course, the most dangerous choice of all.

Whether the country's progressives will in fact work out a new road map of the kind outlined so sketchily here is, at the moment, a matter of sheer guesswork. All that can be said is that some of the most thoughtful are feeling their way in roughly this direction. Fischer, The Lost Liberals, 194 Harper's Magazine 385. (1947)

C. STOCKHOLDERS' PARTICIPATION IN MANAGEMENT

NOTE

RIGHTS OF STOCKHOLDERS IMPLEMENTING THEIR RIGHTS AND DUTIES IN CORPORATE MANAGEMENT

The corporation is an aggregate organization, principally managed by its Board of Directors and officers. Certain rights in management are given to shareholders —namely, to vote to select a management (which may, of course, be limited); the right to vote on changes in the corporate charter; the right to pass upon certain transactions of general interest (for example, arrangements for compensation of directors, employees' pension plans, mortgaging assets of the corporation, dissolution of the enterprise, and so forth).

These functions correspond, roughly, to the functions required of a citizen in a democratic municipality, or a democratic government. As in the political analogue, they cannot effectively perform without certain information, and the stockholder's right to information thus corresponds roughly to one of the fields of civil rights in a democratic state.

As in the case of civil rights, the stockholder's right to information is partly for the purpose of securing effective and intelligent judgment on corporate issues (the corporate vote, etc.) and partly for the purpose of protecting the individual interest of the shareholder (securing information permitting him to prevent the management of the corporation from fraudulent dealing).

The field is not yet fully covered, and the law is developing. We may distinguish, however, between certain types:

(a) Stockholders have certain rights to secure the list of shareholders—this plainly for the purpose of permitting stockholders other than the management to campaign for new directors, or for or against specific stockholder action, and the like. This is information guaranteed to a stockholder to implement his voting right.

(b) Stockholders have the right to information as to the books and accounts of business transactions of the corporation. A stockholder has a right to hold the management of a corporation to certain standards of conduct—attention to business, loyalty, due care, and so forth. The records of the business as shown in the accounts and statements are essential in determining whether these standards have been lived up to.

A stockholder likewise has a right to know approximately the value of his share of stock, and the right to information thus safeguards him individually as well.

(c) Under some circumstances at least, the stockholder has a right to know what action the management has taken in matters of policy. This information is commonly contained in the minute books and records (other than accounts). There is a limited right to have this information made available to him, though the law is not yet well settled on the point, and a clear line has not yet been drawn between information which can probably be kept confidential by the management, and information which the stockholder should have.

(d) Is there a right to technical information—information covering the wide decisions which must be made by management in technological matters? Clearly this is a field to be dealt with primarily by sound managerial judgment, in which stockholders have no right to intervene so long as the judgment is exercised in good faith and with reasonable care. Yet it is perfectly clear that judgment exercised in this field could be oppressive or anti-social. There is no settled law covering this field; yet it is equally plain that the field is there, and will present problems to the law if it does not already.

In this respect it is to be noted that few stockholders would be remotely competent to secure such information, or to analyze or use it if secured. A stockholder in a radio corporation, for instance, seeking information as to what the management was really doing in the field of electronics would need to be an expert to understand the data even if it were presented to him. The generality of stockholders would find such information a hopelessly intricate puzzle. Here there is a possibility other than direct inspection—the simpler rights which have been worked out in other respects. It is possible that the new and growing field may be covered by the device of an expert report—the right to have an impartial, competent, expert go over the information, and report on it, reducing the facts and issues to a form comprehensible to laymen.

On further analysis, it will be seen that a stockholder seeking to establish a right to secure information may be acting in any of three ways:

(1) He may be seeking to put himself and other stockholders in a position to exercise intelligently corporate rights, e.g., voting, as a part of the administration of the corporation itself. The statutory and charter scheme calls for stockholders' judgment on certain matters and as a participating member he is endeavoring to exercise this function;

(2) Or he may be seeking to ascertain or establish his individual right—the value of his share of stock, or the exact interest he has in voting one way or another on any proposition; and so forth. Such information is not in aid of the corporate function, but in aid of his own property and interest;

(3) Or he may be seeking information for use in connection with an object unrelated either to the management of the corporation or to his property interest therein—as when he seeks the list of stockholders for the purpose of selling it to an advertising agency, or seeks the accounts of the corporation for the purpose of turning the information over to a competitor. Here, of course, he seeks information so that it may be used adversely to the corporation and his fellow shareholders. There is always some possibility that information secured in aid of the recognized objectives under paragraphs (1) and (2) may be misused for such purposes. The cases and statutes which follow reflect the evolution of the law up to the present in this respect.

NEW YORK STOCK CORPORATION LAW

§ 45. *Notice of meetings of stockholders.* Whenever under the provisions of this chapter stockholders are required or authorized to take any action at a meeting, the notice of the meeting shall be in writing and signed by the president or a vice-president or the secretary or an assistant secretary. Such notice shall state the purpose or purposes for which the meeting is called and the time when and the place within the state where it is to be held, and a copy thereof shall be served, either personally or by mail, upon each stockholder of record entitled to vote at such meeting, and upon each stockholder of record who, by reason of any action proposed at such meeting, would be entitled to have his stock appraised if such action were taken, not less than ten nor more than forty days before the meeting. If mailed, it shall be directed to a stockholder at his address as it appears on the stock-book unless he shall have filed with the secretary of the corporation a written request that notices intended for him to be mailed to some other address, in which case it shall be mailed to the address designated in such request. The by-laws may require that such notice be also published in one or more newspapers.

DELAWARE GENERAL CORPORATION LAW

Sec. 32. *Meeting of Stockholders; Where; Principal Office; Where; Resident Agent:*—In all cases after the first meeting of the incorporators, where it is not otherwise provided by the by-laws, the meetings of the stockholders of every corporation shall be held at its principal office in this State. The stockholders and directors may, however, hold their meetings and have an office or offices outside of this State, if the by-laws so provide; and every corporation shall maintain a principal office or place of business in this State and shall have a resident agent, who may be either an individual or a corporation, resident of, or located in, this State, in charge thereof.

THE ——— COMPANY

(a New Jersey Corporation)

Minutes of Annual Meeting of Stockholders

MINUTES of the Annual Meeting of the Stockholders of THE ——— COMPANY held at the registered office of the Company, No. 15 Exchange Place, Jersey City, Hudson County, New Jersey, on Wednesday, April 16, 1941, at 10:00 o'clock A.M.

The President of the Company, ———, called the meeting to order.

Nominations having been made, on motion, duly seconded, the Chairman of the Board of Directors, Mr. ———, was elected Chairman of the meeting. Mr. ———, Secretary of the Company, was thereupon duly elected Secretary of the meeting.

The Secretary presented the notice of call of the meeting together with due proof by affidavit that a copy of said notice together with the proxy statement required by Regulation X-14 of the Securities and Exchange Commission had been served upon every stockholder of the Company of record at the close of business on March 19, 1941, that being the date for the determination of the stockholders entitled to notice of and to vote at the meeting, in the manner and within the time provided by the By-Laws of the Company. Said affidavit also covered the mailing to every such stockholder of a copy of the President's letter to stockholders dated March 19, 1941. On motion, duly seconded, the said affidavit, notice and proxy statement were ordered filed with the records of the meeting.

The Chairman stated that the objects of the meeting were (a) to elect a Board of thirteen (13) Directors for the ensuing year and until the election and qualification of their respective successors; (b) to take action upon a proposal that the By-Laws of the Company be amended by adding thereto a new Article providing for the indemnification of directors and officers against suits, in the form set forth in the proxy statement that accompanied the notice of the meeting, and (c) to transact such other business as may properly come before the meeting.

The Secretary presented to the Chairman the transfer books and the stock books, together with a full, true and complete list in alphabetical order, duly certified to by the Secretary of the Company, of all the stockholders entitled to vote at the meeting with the residence of each and the number of shares held by each, and stated that the same had been on file at the principal and registered office of the Company and open to inspection by any stockholder during the ten days immediately preceding the meeting. The said list marked "A" remained open to the inspection of the stockholders and was ordered filed with the records of the meeting.

The Secretary reported that there were present in person or by proxy, stockholders holding 2,608,797 shares of the capital stock of the Company out of a total of 4,396,704 shares issued and outstanding

at the close of business on March 19, 1941, this being the record date for this meeting. The Secretary stated that the above figure of 4,396,-704 shares issued and outstanding did not include 21,254 shares heretofore issued but now held in the treasury of the Company. The Secretary further reported that no additional shares had been issued prior to the date of this meeting.

The Secretary reported the names of the stockholders present in person or by proxy and the number of shares held by each as shown by the list marked "B" which was ordered filed with the records of the meeting; that stockholders holding more than a majority in par value of the outstanding capital stock of the Company were present at the meeting in person or by proxy. The Chairman thereupon announced that a quorum was in attendance at the meeting.

On motion, duly seconded, the proxies presented were ordered filed as a part of the records of the meeting.

The minutes of the last previous annual meeting of stockholders held April 17, 1940, were read and, on motion, duly seconded, were duly approved. On motion, it was voted to proceed with the election of Directors for the ensuing year and by vote of the stockholders present, ——— and ——— were duly appointed to act as Inspectors of Election at this meeting of the stockholders, neither of them being a candidate for the office of Director. The said Inspectors were duly sworn and their oath was ordered filed with the records of the meeting.

Nominations for Directors then being called for, the following names were placed in nomination:

Name	*Name*
———	———
———	———
———	———
———	———
———	———
———	———

———

The Chairman then reported the polls open for the election of Directors, it then being the hour of 10:20 A.M. The meeting thereupon proceeded to the election of thirteen Directors in accordance with the By-Laws, and the stockholders prepared their ballots and delivered them to the Inspectors.

The Secretary then submitted and read to the meeting a further extract from the minutes of said meeting of the Board of Directors held on Tuesday, January 28, 1941, relating to the proposed amendment of the By-Laws of the Company submitted to the stockholders thereof at this meeting. Said extract was in words and figures the following:

"The Chairman presented to the meeting a proposed new By-Law which he stated was of the kind that a number of corporations had recently been adding to their By-Laws, the purpose of such new By-Law being to provide indemnification for directors and officers against expenses incurred by them in connection with suits brought against them by reason of their office and in which they are not held liable.

"General discussion then ensued after which, on motion duly made and seconded, the following resolutions were unanimously adopted by the vote of the Directors present:

"Resolved, that this Board of Directors hereby declares advisable an amendment of the By-Laws of the Company by the addition of a new Article to read as follows:

" 'Each director and officer shall be indemnified by the Company against expenses reasonably incurred by him (including, but not limited to, counsel fees and settlements out of court in amounts approved by the Board of Directors, but not including any case where in the opinion of counsel for the Company the directors and officers affected are liable) in connection with any action, suit or proceeding to which he may be made a party by reason of his being or having been a director or officer of the Company (whether or not he continues to be a director or officer at the time of incurring such expenses), except in relation to matters as to which he shall be adjudged in such action, suit or proceeding to be liable or to have been derelict in the performance of his duty as such director or officer. The foregoing right of indemnification shall not be exclusive of other rights to which any director or officer may be entitled as a matter of law.'

"Further resolved, that a meeting of the stockholders be, and the same hereby is, called to take action upon the adoption of the new By-Law aforesaid, which meeting shall also be the annual meeting of the stockholders to be held April 16, 1941.

"Further Resolved, that if the stockholders at said meeting adopt the new By-Law aforesaid it shall constitute Article XI of the By-Laws of the Company and that the present Article XI be renumbered to be Article XII, and that any changes in references necessitated by the inclusion of said new article shall thereupon be made."

After the reading of the above extract from the minutes of the meeting of the Board of Directors held January 28, 1941, the following preamble and resolution were offered by Mr. ———, who moved their adoption, the said motion being duly seconded by Mr. ———.

Whereas, the Board of Directors of this Company at its meeting held January 28, 1941, (a) declared advisable an amendment of the By-Laws of the Company by adding thereto a new Article providing for the indemnification of directors and officers against suits in the form set forth in the proxy statement which accompanied the notice of this meeting, and (b) called this meeting of stockholders to take action upon a proposal that the By-Laws of the Company be so amended;

Now, therefore, be it resolved, (a) that the By-Laws of this Company be, and they hereby are, amended by adding thereto a new Article in the form set forth in the proxy statement which accompanied the notice of this meeting and reading as follows:

"Each director and officer shall be indemnified by the Company against expenses reasonably incurred by him (including, but not limited to, counsel fees and settlements out of court in amounts approved by the Board of Directors, but not including any case where in the opinion of counsel for the Company the directors and officers affected are liable) in connection with any action, suit or proceeding to which

he may be made a party by reason of his being or having been a director or officer of the Company (whether or not he continues to be a director or officer at the time of incurring such expenses), except in relation to matters as to which he shall be adjudged in such action, suit or proceeding to be liable or to have been derelict in the performance of his duty as such director or officer. The foregoing right of indemnification shall not be exclusive of other rights to which any director or officer may be entitled as a matter of law."
and (b) that said new Article of the By-Laws shall be numbered in accordance with the resolutions of the Board of Directors adopted at their said meeting held January 28, 1941.

The Chairman directed that a vote by ballot be taken upon said preamble and resolution.

Upon the vote by ballot on the foregoing preamble and resolution 2,512,470 shares of the capital stock, constituting more than a majority in interest of the capital stock of the Company represented at the meeting, voted in the affirmative and 94,266 shares voted in the negative. The Chairman thereupon declared that said preamble and resolution had been duly adopted by the affirmative vote of more than a majority in interest of the capital stock of the Company represented at the meeting and that, therefore, said amendment of the By-Laws of the Company had been duly adopted.

The Chairman stated to the stockholders that the minute book containing the minutes of the proceedings of the Board of Directors since the last annual meeting of the stockholders held April 17, 1940, was on hand, on the table, and would remain open to the inspection of the stockholders at any time during the meeting. Included in the minute book was a statement showing the provision that has been made for compensation of each officer and director in their official capacities for the year 1941, as well as the total compensation of each of the officers and directors of the Company for the year 1940 and certain other years.

The Chairman presented to the meeting a copy of the annual report of the Company and all its subsidiary companies for the year ended December 31, 1940, said annual report containing, among other things, a comment or analysis signed by ———, President, a consolidated balance sheet as of December 31, 1940 and 1939 and related statements of consolidated net income, earned surplus, and capital surplus of The ——— Company and its subsidiary companies for the years ended December 31, 1940, and 1939, and an accountants' certificate of Messrs. Haskins & Sells. The Chairman presented to the meeting proof by affidavit that a copy of the said annual report had been mailed to stockholders of record on March 7, 1941, and also to persons who became stockholders of record between March 7, 1941, and the close of business of March 19, 1941.

The Chairman stated that he and the officers of the Company would be glad to answer any pertinent and proper inquiry by any stockholder as to any matter referred to in the said minutes of the Directors or in the annual report to the stockholders for the year ended December 31, 1940.

An informal recess was taken to give the stockholders then present a further opportunity to examine the papers, etc. which had been submitted to the meeting.

During the recess the President of the Company ———, commented at some length on various phases of the business of the Company, and some of the problems facing it during the balance of the year.

At this point the Inspectors reported that since the organization of the meeting subsequent to the taking of the ballots on the amendment of the By-Laws proxies for an additional 1,835 shares of stock had been filed, and that all of them were in favor of said amendment of the By-Laws.

The hour of 11:20 A.M. having arrived and the polls having remained open one hour, the Chairman thereupon declared the polls closed for the election of Directors. The Inspectors thereupon presented their report in writing showing that they had received and counted the ballots of the stockholders and that 2,610,632 votes had been cast in favor of the following thirteen gentlemen as Directors of the Company for the ensuing year, namely:

[List given.]

that no votes had been cast for any other person, and that the above named gentlemen had been unanimously elected Directors, the holders of more than a majority of the outstanding capital stock of the Company having voted in favor of these gentlemen.

On motion, duly seconded, the report of the Inspectors was accepted, approved and ordered filed with the records of the meeting, a majority of the stockholders present in person or by proxy voting in the affirmative.

The Chairman thereupon announced that the above named gentlemen had been duly elected Directors of the Company, to hold office until the next annual meeting of the stockholders, and until their successors are elected and qualified.

On motion, duly seconded, the meeting then adjourned.

———————

Chairman

———————

Secretary of the Meeting

NORTH MILWAUKEE TOWN-SITE COMPANY NO. 2 v. BISHOP.

Supreme Court of Wisconsin, 1899. 103 Wis. 492, 79 N.W. 785.

Action by the North Milwaukee Town-Site Company No. 2 against Frank Bishop, Jr. Judgment for defendant, and plaintiff appeals. Affirmed.

The plaintiff is a corporation. The defendant is the owner of 58 shares of its capitál stock, of the par value of $100, upon which assessments to the amount of $54 have been paid. On April 20, 1896, the plaintiff's board of directors adopted the following resolution: "Resolved, that a call be, and hereby is, made upon the unpaid portion of subscription for stock in this company, amounting to $46 per share, the same to be paid thirty days from date, either in cash or by a promise to pay in the form of a land contract or contracts; and when the same shall be paid that the stock shall be shown as full-paid on the books of the company; and the secretary is hereby directed to proceed and use all legal means necessary for the collection of any unpaid portion of said call, and, if any party refuse or neglect to make such payment, proper steps be taken to advertise and foreclose the stock upon which such payment shall not have been made." At the same time the board passed the following resolution: "Resolved, that the secretary be, and hereby is, instructed to notify the stockholders of this company of said call by mailing to each stockholder a copy of said resolution." The defendant failed to pay the call so made and this action was commenced to enforce payment. After hearing the plaintiff's evidence, the court granted a nonsuit. From a judgment for the defendant, the plaintiff appeals.

BARDEEN, J. (after stating the facts). The judgment of nonsuit was justified upon either of two grounds: * * *

2. No proof was made of giving notice of such call according to the by-laws of the corporation. Section 1754, Rev.St. 1898, provides that, "unless otherwise expressly provided by law or the articles of organization, the directors of any corporation may call in the subscriptions to the capital stock by installments, in such proportion and at such times as they shall think proper, by giving such notice thereof as the by-laws shall prescribe." It was admitted on the trial that no by-law of the corporation in this regard had ever been adopted. The action of the board was attempted to be justified, however, by showing that the board, after adopting the resolution for the call, adopted another resolution instructing the secretary to notify each stockholder thereof by mailing to him a copy of said resolution. This latter action of the board is claimed to be equivalent to a regular by-law, and answers all the purposes of the statute. The difficulty with this contention is that the board of directors have no power to enact by-laws unless so authorized by law, by the articles of organization, or by proper action of the stockholders. A by-law is a permanent and continuing rule for the government of the corporation and its officers. The power to enact them resides primarily with the stockholders. They have few functions to perform, and this right to make by-laws is an essential and

an important one. It is a power that the directors have no inherent right to exercise. * * *

It is argued, however, that because section 1776, Rev.St., provides that "the stock, property, affairs, and business" of every corporation shall be under the care of and be managed by a board of directors, the power to enact proper by-laws may be implied therefrom. As before intimated, the power to make by-laws is incident to the corporation, itself, and results from the necessity of such a power to enable the body politic to answer to the purposes for which it was created. It being a valuable and important right, it ought not to be taken away by inference or implication. The power given to the directors to control the stock and business of the corporation may exist, and be entirely consistent with the power of the stockholders to say upon what terms and conditions the stock of the corporation shall be paid for and issued. We therefore hold that, unless taken away by the charter, or some law of the state, the power to enact suitable by-laws rests in the stockholders of the corporation, and not in the board of directors. * * * The judgment of the superior court of Milwaukee county is affirmed.

1. RIGHT TO VOTE: PROXIES AND PROXY STATEMENTS

NEW YORK STOCK CORPORATION LAW

§ 47. *Qualification of voters.* Unless otherwise provided in the certificate of incorporation or other certificate filed pursuant to law, every stockholder of record of a stock corporation shall be entitled at every meeting of the corporation to one vote for every share of stock standing in his name on the books of the corporation. The board of directors of a stock corporation, unless otherwise provided in the certificate of incorporation or other certificate filed pursuant to law or in the by-laws, may prescribe a period, not exceeding forty days prior to the date of meetings of the stockholders or prior to the last day on which the consent or dissent of stockholders may be effectively expressed for any purpose without a meeting, during which no transfer of stock on the books of the corporation may be made; or in lieu of prohibiting the transfer of stock may fix a time not more than forty days prior to the date of any meeting of stockholders or prior to the last day on which the consent or dissent of stockholders may be effectively expressed for any purpose without a meeting as the time as of which stockholders entitled to notice of and to vote at such a meeting or whose consent or dissent is required or may be expressed for any purpose, as the case may be, shall be determined, and all persons who were holders of record of voting stock at such time and no others shall be entitled to notice of and to vote at such meeting or to express their consent or dissent, as the case may be. Except in cases of express trust, or in which other provision shall have been made by written agreement between the parties, the record holder of stock which shall be held by him as security or which shall actually belong to another, upon demand therefor and payment of necessary expenses thereof, shall issue to such pledger or to such actual owner of such stock, a

proxy to vote thereon. A stockholder shall not sell his vote or issue a proxy to vote to any person for any sum of money or anything of value. The books and papers containing the list of stockholders shall be produced at any meeting of the stockholders upon the request of any stockholder. If the right to vote at any such meeting shall be challenged, the inspectors of election, or other person presiding thereat, shall require such books, if they can be had, to be produced as evidence of the right of the person challenged to vote at such meeting, and all persons who may appear from such books to be stockholders of the corporation entitled to vote may vote at such meeting in person or by proxy subject to the provisions of this chapter.

§ 49. *Cumulative voting.* The certificate of incorporation of any stock corporation or other certificate filed pursuant to law may provide that at all elections of directors of such corporation each stockholder shall be entitled to as many votes as shall equal the number of votes which (except for such provisions as to cumulative voting) he would be entitled to cast for the election of directors with respect to his shares of stock multiplied by the number of directors to be elected, and that he may cast all of such votes for a single director or may distribute them among the number to be voted for, or any two or more of them, as he may see fit, which right, when exercised, shall be termed cumulative voting. The stockholders of a corporation heretofore formed, who, by the provisions of laws existing on April thirtieth, eighteen hundred and ninety-one, were entitled to the exercise of such right, may hereafter exercise such right, according to the provisions of this section.

§ 51. *Limitations on right to vote.* Except as in this section otherwise provided, the certificate of incorporation or other certificate filed pursuant to law may provide, either absolutely or conditionally, that the holders of any designated class or classes of stock shall not be entitled to vote, or it may otherwise limit or define the respective voting powers of the several classes of stock, and, except as otherwise in this section provided, such provisions of such certificate shall prevail, according to their tenor, in all elections and in all proceedings, over the provisions of any statute which authorizes any action by the vote or written consent of the holders of all the shares, or of a specified proportion of the shares of the corporation. Unless specifically excluded by the certificate of incorporation or other certificate filed pursuant to law from the right to vote in a proceeding (a) for mortgaging the property and franchises of the corporation pursuant to section sixteen, (b) for authorizing any guaranty pursuant to section nineteen, (c) for sale of the franchises and property pursuant to section twenty, (d) for consolidation pursuant to section eighty-six, (e) for voluntary dissolution pursuant to section one hundred and five, or (f) for change of name pursuant to the general corporation law, the holders of all shares of stock shall be entitled to vote in every such proceeding.

In any proceeding for excluding or limiting the right of the holders of any class or classes of stock to vote, except as the same may be limited by the voting rights that may be given to the holders of new shares of any class that may be authorized in that or some later proceeding, the holders of all shares of such class or classes of stock shall

be entitled to vote regardless of any provision to the contrary in the certificate of incorporation or other certificate filed pursuant to law.

In a proceeding pursuant to section thirty-six for classifying or reclassifying, as defined in paragraph (E) of said section, any authorized or outstanding shares, the holders of all shares of any class or classes that will be adversely affected by such action shall be entitled to vote, and in a proceeding pursuant to said section for authorizing shares having preferences which will be in any respect superior to the rights of any outstanding shares, the holders of all outstanding shares whose rights will be subordinated by such action shall be entitled to vote, in either event regardless of any provision to the contrary in the certificate of incorporation or other certificate filed pursuant to law.

Notwithstanding any of the provisions of this section, the consent or vote required for revival of corporate existence under section forty-nine of the general corporation law shall be governed soley by the provisions thereof.

NEW YORK GENERAL CORPORATION LAW

§ 19. *Proxies.* Every member of a corporation, except a religious corporation, entitled to vote at any meeting thereof may vote by proxy.

Every proxy must be executed in writing by the member, or by his duly authorized attorney. No proxy shall be valid after the expiration of eleven months from the date of its execution unless the member executing it shall have specified therein its duration. Every proxy shall be revocable at the pleasure of the person executing it or of his personal representatives or assigns; but the parties to a valid pledge or to an executory contract of sale may agree in writing as to which of them shall vote the stock pledged or sold until the contract of pledge or sale is fully executed. * * *

§ 20. *Challenges.* Every member of a corporation offering to vote at any meeting of the corporation, if challenged by an inspector of election or other officer presiding at such meeting, or by any other member present, shall take and subscribe the following oath: "I do solemnly swear that in voting at this election I have not, either directly, indirectly or impliedly received any promise or any sum of money or any thing of value to influence the giving of my vote or votes at this meeting or as a consideration therefor." Any person offering to vote as proxy shall present his proxy and, if so challenged, take and subscribe the following oath: "I do solemnly swear that I have not, either directly, indirectly or impliedly, given any promise or any sum of money or any thing of value to induce the giving of a proxy to me to vote at this meeting, or received any promise or any sum of money or any thing of value to influence the giving of my vote at this meeting, or as a consideration therefor." The inspectors or persons presiding at the election may administer such oath, and all such oaths and proxies shall be filed in the office of the corporation. A member or proxy who shall fail to take such oath when so challenged shall not be permitted to vote.

DELAWARE GENERAL CORPORATION LAW

Sec. 17. *Power of Stockholders to Vote in Person or by Proxy; Limitation of Power; Closing of Transfer Books or Fixing Date for Determination of Stockholders of Record for Certain Purposes; Cumulative Voting; Quorum:*—Unless otherwise provided in the Certificate of Incorporation, each stockholder, shall at every meeting of the stockholders be entitled to one vote in person or by proxy for each share of the capital stock held by such stockholder, but no proxy shall be voted on after three years from its date, unless said proxy provides for a longer period, and, except where the transfer books of the corporation shall have been closed or a date shall have been fixed as a record date for the determination of its stockholders entitled to vote, as hereinafter provided, no share of stock shall be voted on at any election for directors which shall have been transferred on the books of the corporation within twenty days next preceding such election of directors.

The board of directors shall have power to close the stock transfer books of the corporation for a period not exceeding fifty days preceding the date of any meeting of stockholders or the date for payment of any dividend or the date for the allotment of rights or the date when any change or conversion or exchange of capital stock shall go into effect or for a period of not exceeding fifty days in connection with obtaining the consent of stockholders for any purpose; provided, however, that in lieu of closing the stock transfer books as aforesaid, the by-laws may fix or authorize the board of directors to fix in advance a date, not exceeding fifty days preceding the date of any meeting of stockholders, or the date for the payment of any dividend, or the date for the allotment of rights, or the date when any change or conversion or exchange of capital stock shall go into effect, or a date in connection with obtaining such consent, as a record date for the determination of the stockholders entitled to notice of, and to vote at, any such meeting and any adjournment thereof, or entitled to receive payment of any such dividend, or to any such allotment of rights, or to exercise the rights in respect of any such change, conversion or exchange of capital stock, or to give such consent, and in such case such stockholders and only such stockholders as shall be stockholders of record on the date so fixed shall be entitled to such notice of, and to vote at, such meeting and any adjournment thereof, or to receive payment of such dividend, or to receive such allotment of rights, or to exercise such rights, or to give such consent, as the case may be, notwithstanding any transfer of any stock on the books of the corporation after any such record date fixed as aforesaid.

The Certificate of Incorporation of any corporation may provide that at all elections of directors of such corporation, each stockholder shall be entitled to as many votes as shall equal the number of his shares of stock multiplied by the number of directors to be elected, and that he may cast all of such votes for a single director or may distribute them among the number to be voted for, or any two or more of them as he may see fit, which right when exercised, shall be termed cumulative voting. * * *

Subject to the provisions of this Chapter in respect of the vote that shall be required for a specified action, the Certificate of Incorporation or by-laws of any corporation may specify the number of shares and/or the amount of other securities having voting power the holders of which (or in the case of a corporation with no capital stock, the number of the members thereof having voting power who) shall be present or represented by proxy at any meeting in order to constitute a quorum for, and the votes that shall be necessary for, the transaction of any business.

SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C.A. § 78

PROXIES

Sec. 14. (a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member to give a proxy, consent, or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[1]

NOTE

The following proxy material was filed in compliance with Regulations x–14:

KENNECOTT COPPER CORPORATION

120 BROADWAY, NEW YORK 5, N. Y.

NOTICE of ANNUAL MEETING of STOCKHOLDERS

New York, N. Y., March 31, 1947

The Annual Meeting of stockholders of Kennecott Copper Corporation will be held at the principal office of the Corporation, No. 120 Broadway, New York, N. Y., on the 6th day of May, 1947, at 10:00 o'clock a. m., Eastern Standard Time (11:00 o'clock a. m., Eastern Daylight Saving Time) for the following purposes: (a) To elect

1 See Rules under Section 14 of the Act, Regulations X–14 (revised as of December 18, 1947).

fourteen (14) directors for the ensuing year and (b) To consider and transact such other business as may properly come before the meeting.

The minutes of the meetings of the Board of Directors, held since the last annual meeting of stockholders, will be presented at the meeting and will be open for inspection.

March 31, 1947 has been fixed as the record date for the determination of stockholders entitled to notice of and to vote at such Annual Stockholders' Meeting.

The transfer books will not close.

Stockholders who do not expect to attend the Annual Meeting are requested to sign and return the enclosed Proxy in the envelope (prepaid for United States stockholders) which is enclosed herewith.

A. S. Cherouny, *Secretary.*

PROXY STATEMENT

To the Stockholders of

Kennecott Copper Corporation:

At the Annual Meeting of Stockholders of Kennecott Copper Corporation (hereinafter called "Corporation") to be held May 6, 1947, it is intended that votes shall be cast for the election of fourteen (14) persons to the Board of Directors of the Corporation for the ensuing year. There are 10,821,051 shares of the capital stock of the Corporation outstanding and entitled to vote at this Annual Meeting.

The enclosed Proxy is solicited by the Management of the Corporation.

Any proxy when signed will be revocable at any time before exercised; and the giving of such proxy will not affect the right of any stockholder to vote in person should he later find it convenient to attend the meeting.

Nominees for Election as Directors

The nominees designated by the Management for the directorships of the Corporation to be filled pursuant to the enclosed form of proxy *all of whom are now members of the Board of Directors* and for whom it is intended that votes will be cast pursuant to the proxy, are set out below. In the event that a vacancy among the original nominees is occasioned by death or any other reason prior to the meeting, the proxy will be voted for a substitute nominee or nominees designated by the Management and for the remaining nominees below. Opposite the name of each nominee is shown (a) his principal occupation, (b) the year in which he first became a Director and (c) the number of shares of stock of the Corporation of which he was the beneficial owner as of February 28, 1947—such statement as to stock ownership being made on the basis of information furnished to the Corporation by each nominee at the request of the Corporation.

Name	Principal Occupation	Year in Which First Became a Director	Number of Shares
F. S. Chase	Retired. Former President of Chase Brass & Copper Co. Incorporated	1929	1,800
Charles D. Dickey	Vice President of J. P. Morgan & Co. Incorporated	1941	1,000
Henry S. Drinker	Attorney. Member of the firm of Drinker Biddle & Reath	1942	100
E. A. Guggenheim	Guggenheim Brothers	1916	50,443(a)
S. R. Guggenheim	Guggenheim Brothers	1921	162,835
Henry O. Havemeyer	President of Brooklyn Eastern District Terminal	1915	360
Arthur W. Page	Director of American Telephone and Telegraph Company and The Chase National Bank of the City of New York	1943	100
Alfred P. Sloan, Jr.	Chairman of the Board of General Motors Corporation	1943	4,600(b)
E. T. Stannard	President of Kennecott Copper Corporation	1929	1,500
Robert G. Stone	Partner of Hayden, Stone & Co.	1937	400
Charles L. Tutt	Chairman of the Board of The First National Bank of Colorado Springs	1940	658(c)
C. T. Ulrich	Vice President and Treasurer of Kennecott Copper Corporation	1918	4,000
Medley G. B. Whelpley	Industrial Development and Management	1937	150
George Whitney	President of J. P. Morgan & Co. Incorporated	1924	100

(a) 28,029 of these shares are held by a trust in which Mr. E. A. Guggenheim has a contingent interest; 19,650 of these shares are held by a trust in which Mr. Guggenheim has a life interest and the balance of 2,764 shares are held by a trust in which Mr. Guggenheim has a contingent interest.

(b) These shares are owned by New Castle Corporation, a personal holding company, 50.05% of the capital stock of which is owned by Mr. Sloan.

(c) 588 of these shares are owned by Securities and Investments Corporation, of which Mr. Tutt owns all but directors' qualifying shares.

Remuneration And Related Matters

The following information is given for the year 1946 with respect to each person who acted as a director of the Corporation during such year, each person nominated for election as a director and each person who has acted as an officer but not as a director and who has

received payments or remuneration totalling more than $20,000 during such year:

Name	Aggregate amount of remuneration received from the Corporation and its subsidiaries directly and indirectly	Amount of excess of remuneration received in 1946 over that received in 1945	Payments by Corporation to the Retirement Fund(a)	Estimated annual benefits under Retirement Plan (b)
E. T. Stannard	$125,940	—	$4,164	$25,000
C. T. Ulrich	60,730	—	2,869	16,020
F. S. Chase	550	—	—	7,320
Charles D. Dickey	670	—	—	—
Henry S. Drinker	650	—	—	—
E. A. Guggenheim	170	—	—	—
S. R. Guggenheim	620	160	—	—
Henry O. Havemeyer	650	130	—	—
Arthur W. Page	650	830	—	—
Alfred P. Sloan, Jr.	840	—	—	—
Robert G. Stone	730	680	—	—
Charles L. Tutt	670	—	—	—
Medley G. B. Whelpley	1,080	—	—	—
George Whitney	640	—	—	—
D. D. Moffat	60,050	—	2,869	14,520
J. C. Kinnear	50,020	6,667	2,369	11,220
R. C. Klugescheid	40,180	3,980	1,869	11,220
R. L. Coe	36,000	3,000	1,669	9,720

(a) The Corporation in 1946 paid into the Retirement Fund, on account of all members of the Retirement Plan but not allocated to the individual members, a further contribution of $249,663, this being the amount estimated by the Actuary for the Fund to be necessary in that year to meet the reserve requirements of the Fund.

(b) Except as to Mr. Chase, who is retired, the amounts listed in this column have been estimated on the assumption that the individual will continue in the employ of the Corporation until retirement age, will continue to receive the same salary as at present and that the Retirement Plan as presently constituted will continue in effect.

No director nor officer nor any person nominated for election as director was indebted to the Corporation and its subsidiaries at any time during the year 1946.

The aggregate remuneration received from the Corporation and its subsidiaries by all directors and officers of the Corporation as a group for 1946 was $453,590, which is $17,467 more than was received by this group for the year 1945. There was paid into the Retirement Fund by the Corporation in 1946 on account of this group a total of $18,669 exclusive of the further contribution paid on account of all members referred to in footnote (a) to the table concerning Remuneration and Related Matters.

The number of employees of the Corporation and its subsidiaries (other than officers and directors of the Corporation) who during the last fiscal year received from the Corporation and its subsidiaries remuneration in excess of $20,000 is shown in the following table:

Salary Group	Number of Employees	Aggregate Amount
$20,000–$50,000	11	$306,972
50,000–100,000	none	none
Over $100,000	none	none

The only remuneration paid or accrued in 1946 by the Corporation in excess of $20,000 other than to directors, officers and employees was the sum of $24,828 to Loomis, Suffern & Fernald, certified public accountants, for services in connection with accounting and tax matters, and $25,000 to Covington, Burling, Rublee, Acheson & Shorb for legal services.

Interest Of Directors In Transactions With Corporation

J. P. Morgan & Co. Incorporated, of which Messrs. Whitney and Dickey are officers, acts as Trustee under the Trust indenture relative to the Corporation's Retirement Fund. During the year 1946 certain subsidiaries of the Corporation sold, in the ordinary course of business, copper and fabricated products to various divisions of General Motors Corporation of which Mr. Sloan is Chairman of the Board.

Solicitation Of Proxies

The expense involved in the solicitation of proxies for the Annual Meeting of Stockholders will be borne by the Corporation. The Corporation intends to reimburse banks, brokers and other persons holding stock in their names or in the names of nominees for expenses, estimated at approximately $1,500, in sending proxy material to principals.

Other Matters

As stated in the Notice of Meeting, the matters to be presented to stockholders at the Annual Meeting are (a) the election of directors and (b) the transaction of all such other business as may properly come before the meeting. The Management does not intend to bring any business before the meeting other than the election of directors and does not now know of any other business that will be presented

by others for action by stockholders at said meeting. However, if any other business shall properly come before the meeting, it is intended that votes will be cast pursuant to said proxy in respect of any such business in accordance with the best judgment of the person or persons acting under said proxy.

Auditors

Messrs. Loomis, Suffern & Fernald, Certified Public Accountants of 80 Broad Street, New York 4, N. Y., were appointed as independent auditors of the accounts of this Corporation and of its subsidiaries for the year 1947. No approval of this appointment is requested. In accordance with past practice, one of the partners of Loomis, Suffern & Fernald will be present at the Annual Meeting for the purpose of answering questions of stockholders relative to accounting matters.

Annual Report

An Annual Report for the year 1946 was mailed to stockholders on March 6, 1947. Reference to the Annual Report is not intended and shall not be construed as incorporating in the proxy material, sent to stockholders in connection with the Annual Meeting to be held May 6, 1947, said Annual Report or any of the statements or information therein contained.

The Corporation welcomes the comments of its stockholders on matters concerning the Corporation's business.

By Order of the Board of Directors,

Dated, March 31, 1947. A. S. Cherouny, *Secretary*.

KENNECOTT COPPER CORPORATION

PROXY

KNOW ALL MEN BY THESE PRESENTS, that the undersigned hereby constitutes and appoints E. T. STANNARD, C. T. ULRICH and GEORGE WHITNEY or any one of them the true and lawful attorney or attorneys of the undersigned, with power of substitution, to attend the Annual Meeting of the Stockholders of Kennecott Copper Corporation to be held at its office, No. 120 Broadway, New York, N. Y., on the 6th day of May, 1947, and any adjournment or adjournments thereof and there to act and vote for and in the name of the undersigned at said meeting or meetings in every way as fully as the undersigned would be entitled to do if personally present upon the following matters: (a) to elect fourteen (14) directors to serve for the ensuing year; and (b) to vote in respect of all such other matters as may properly come before the meeting.

Witness, the hand and seal of the undersigned this ——— day of ———, 1947. ——————— (L. S.)

WYATT et al. v. ARMSTRONG et al.

Supreme Court of New York, Special Term, 1945. 186 Misc. 216, 59 N.Y.S.2d 502.

Proceeding in the matter of the petition of Kenneth S. Wyatt and others, on their own behalf and on behalf of all bondholders and stockholders of Third Avenue Transit Corporation, against Malcolm A. Armstrong and others for an order to set aside the election of directors of Third Avenue Transit Corporation at a meeting held on May 9, 1945, and at a meeting held May 29, 1945, and the subsequent election of officers of the corporation, and for an order directing the holding of a new meeting of stockholders for the purpose of electing a board of directors.

Decision in accordance with opinion setting aside elections and directing a new election.

HOFSTADTER, JUSTICE. This is an application pursuant to section 25 of the General Corporation Law for an order vacating and declaring void the election of directors of the Third Avenue Transit Corporation held on the 9th of May, 1945, and directing a new election to take place forthwith, and for other relief.

Stripped of its plethora of irrelevant and redundant allegations, the petition alleges that the election held on May 9, 1945, should be set aside because the proxies voted thereat were secured by withholding vital information from the electors—information which might have affected their vote had it been furnished them. In brief, it appears and is not seriously challenged in any of the replying papers, that Mr. Fred Cox signed and delivered to Mr. Malcolm A. Armstrong an undated resignation on or prior to the 9th day of May, 1945, and that the purpose of this resignation was to enable Armstrong and John A. Kaye between them to control the board of directors. The petition also alleges that other nominees, on whose behalf proxies were solicited, aside from Mr. Cox, likewise furnished resignations in advance; but it does not appear that any others actually signed undated resignations at or prior to the election held on May 9th. In addition, numerous allegations of fraud and conspiracy against the respondents are generally charged in the petition and in the affidavits of the Attorney General of the State of New York requesting leave to intervene in support of the petition. A number of the respondents, who are directors of the corporation as a result of the election on May 9, 1945, have likewise joined in the request that the election be set aside and that a new election be ordered.

The general picture that emerges for the numerous papers filed, both in support and in opposition to the pending application, is one of confusion and backstage machinations for the purpose of securing control of an important public utility. Enough is alleged and either explicitly conceded or not denied to show that when the election on May 9, 1945, was held, the electors who had given their proxies to the various committees soliciting them, had been kept in ignorance of the true state of affairs, and were, indeed, unaware of the fact that their proxies were being used, at least in the case of the so-called "Investors Group," for the purpose of handing over the control of the corporation

to others than those named as the nominees for the directorships involved.

Such conduct on the part of those who are in the highest fiduciary relationship with stockholders and bondholders of a corporation is reprehensible in the extreme and should not be tolerated in a court of equity. Section 25 of the General Corporation Law[2] is specifically designed for the purpose of enabling a court of equity to correct a situation of this kind when brought to its attention. I have had occasion, in another case, to state the general principles of law applicable to cases of this kind.[3] In brief, it may be said that under section 25 of the General Corporation Law, the court is not confined to strict legal considerations, but has broad equitable powers which should be exercised whenever the election sought to be reviewed is so clouded with doubt or tainted with questionable circumstances that the standards of fair dealing require the court to order a new, clear and adequate expression of security holders' will. No other conclusion could be drawn from the mandate of the court contained in Matter of Kaminsky, 251 App.Div. 132, 295 N.Y.S. 989, 999, affirmed 277 N.Y. 524, 13 N.E.2d 456, where the court said: "If the result is not free from suspicion, or is clouded with doubt, and justice demands, we may in all fairness require the parties to start all over again. When right, justice and fair play require, a new election should be ordered." [Citing cases.]

The rule is clearly applicable to this case. The security holders entitled to vote were misled by being deprived of information which might easily have affected their judgment. The result is, therefore, not only clouded in doubt but highly suspicious. Those who hold positions of trust and confidence are under a duty so to conduct themselves as to avoid the inference that they are seeking for self interest, to mislead the real owners of their corporations. Upon their failure to abide by those principles of fair dealing, the court is under a duty to deal with them as justice may require.

Numerous objections to the granting of the petition have been urged before me, both on oral argument and in briefs submitted by various respondents. * * *

Secondly, it is alleged that even if the election of May 9, 1945, was improper, and should be set aside, that nevertheless the incumbent directors must be allowed to continue in office and that no new election should be held because they were likewise elected at a meeting of the old board held on May 29, 1945. On that date, it appears in the record the members of the old board, who had been defeated at the May 9th election but who nevertheless maintained that they had a right to continue in office, met and resigned one by one, and as each member resigned, a substitute was elected from the slate that had secured a plurality at the May 9th election.

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2 Section 25 of the General Corporation Law provides as follows: "Powers of supreme court respecting elections. Upon the application of any member aggrieved by an election, and upon notice to the persons declared elected thereat, the corporation and such other persons as the court may direct, the supreme court at a special term thereof shall forthwith hear the proofs and allegations of the parties, and confirm the election or order a new election, as justice may require."

3 See Matter of Scheuer, (London Terrace, Inc.), — Misc. —, 59 N.Y.S.2d 500, confirming the report of Referee Bachner. The cases are collected in the report and the principles of law involved stated extensively.

The circumstances which led to this unusual procedure arose out of the fact that the stockholders of the corporation changed the date of the annual election from November to May 9th. It is argued that this change of date could not have the effect of cutting short the term of office of the directors who had been elected in November, 1944. The argument is based upon decisions of courts in some states in which it has been held that a mere change in the date of the annual meeting for the election of directors cannot affect the term of office of the directors then in office. The principal case relied upon in support of this proposition is Toledo Traction v. Smith, D.C., 205 F. 643, construing the Ohio corporation law. It is to be noted, however, that in that case the court points out that "All the Ohio statutes speak of annual elections at which directors shall be chosen." 205 F. at page 646. The New York statutes however, do not require annual elections, the only reference to annual elections in our corporation law being contained in section 55 of the Stock Corporation Law, which provides that "at least one-fourth in number of the directors of every stock corporation shall be elected annually." That section, however, is intended to provide a method for staggering the election of directors and the word "annual" there used does not preclude elections for a shorter term. Indeed, section 25 of the General Corporation Law itself, which authorizes the court to order a special election, would not be effective if the directors elected at such election were required to hold office for a full year. On the contrary, it is perfectly clear that the directors to be elected at the special election to be ordered by the court will, in this case, hold office only until May 9, 1946, when the regular annual meeting of stockholders takes place.

But even if it be admitted that the election of May 9th was ineffective to curtail the term of the board then in office, it would merely follow that that election was a nullity. The board that was then in office has since resigned and we are then faced with the question of whether the action taken by that board on May 29, 1945, may be allowed to stand. I am of opinion that to do so would be contrary to the requirements of justice in the instant case. The resignations and elections which took place on May 29, 1945, were a result of pressure brought by the present incumbents upon the old board. Indeed, the proceedings taken on that date may well be considered as part and parcel of the whole effort which resulted in the illegal election on May 9th. The present incumbents came into office by securing votes from security holders on the basis of concealment amounting to misrepresentation. Having secured the so-called plurality of security holders' votes, then they proceeded to bring pressure upon the old board to regularize their election by the corporate maneuvering which took place on May 29th. I am of opinion that what took place on that date must be regarded as part of the same transaction which occurred on May 9th and tainted with the same evils that section 25 of the General Corporation Law is designed to remedy.

Third, it is argued that the petitioners have no standing in this proceeding because they are bondholders rather than stockholders. But they are bondholders who are entitled to vote for the election of directors and as such they are members of the corporation who are

"aggrieved" within the meaning of section 25 of the General Corporation Law. Moreover, upon the oral argument, an application was made for leave of stockholders to intervene in this proceeding. Such application is hereby granted and the proceeding continued on behalf of stockholders as well as bondholders. In addition, the petition is joined in by directors of the corporation whose right to question the regularity of these proceedings under section 25 of the General Corporation Law cannot be doubted.

The public interest in the proper conduct of corporate elections is a matter of great concern in the commercial community in which we live. It is of utmost importance that the many millions of security holders throughout the land should have reason to rely upon the integrity of those who manage the affairs of our corporations; that they be permitted the same freedom in the expression of their wishes with respect to the election of directors that is accorded to citizens in political elections. The affidavit filed by the learned Attorney General of the State of New York contains important material, though not specifically relevant to the precise issues before me, and was no doubt presented to the court for the purpose of demonstrating that the atmosphere surrounding the proceedings taken by this corporation on May 9 and May 29, 1945, was completely devoid of that candid and honest dealing which alone justify the refusal of the court to interfere with the internal affairs of a corporation. Our courts have wisely adopted a policy of judicial self-limitation, refraining, wherever possible, from interfering by judicial fiat with management of matters entrusted to directors, officers and stockholders of corporate enterprises. But the court would fail in its plain duty if it did not interpose its equitable process to prevent the continued perpetuation of fraud or to right wrongs which have resulted in depriving security holders of their complete freedom to vote at corporate elections in the light of a complete disclosure of all the relevant facts and circumstances.

The matters before me are, therefore, disposed of as follows: (1) The application to set aside the elections of directors of the Third Avenue Transit Corporation held on May 9 and May 29, 1945, is granted; (2) a new election is directed to be held on a date to be fixed in the order to be entered herein, within thirty days from the date of said order; (3) notice of said meeting is to be given to all security holders entitled to vote thereat, in accordance with the provisions of the bylaws of the corporation; (4) the motion to dismiss the petition is hereby denied; (5) the motion to expunge from the record portions of the affidavit of the Attorney General, sworn to the 26th day of November, 1945, is likewise denied; (6) the court will entertain an application, but only on consent of all the parties hereto, for the appointment of a referee to supervise the forthcoming special election, and to pass upon all letters and communications to be sent to security holders for the solicitation of proxies.

Settle order on notice.

2. RIGHT TO STOCK LIST

NEW YORK STOCK CORPORATION LAW

§ 10. *Books to be kept; inspection; presumptive evidence; penalties.* Every stock corporation shall keep at its office correct books of account of all its business and transactions, and a book to be known as the stock book, containing the names, alphabetically arranged, of all persons who are stockholders of the corporation, showing their places of residence, the number of shares of stock held by them respectively, the time when they respectively became the owners thereof, and the amount paid thereon. If any such corporation has in this state a transfer agent, such stock book may be deposited in the office of such agent, or may be kept in the office of the corporation, at its option, provided, that if kept in the office of the transfer agent there shall be posted in a conspicuous place in the office of the corporation a statement setting forth that fact with the name and address of the transfer agent where the stock book is kept. The stock book of every such corporation shall be open daily, during at least three business hours, for inspection by any judgment creditor of the corporation; or by any person who shall have been a stockholder of record in such corporation for at least six months immediately preceding his demand; or by any person holding or thereunto in writing authorized by the holders of at least five per centum of all its outstanding shares; provided (a) that such inspection shall not be for the purpose of communicating with stockholders in the interest of a business or object other than the business of the corporation, and (b) that such stockholder or other person has not within five years sold or offered for sale any list of stockholders of such corporation or any other corporation, or aided or abetted any person in procuring any stock list for any such purpose; and provided further that such inspection may be denied to such stockholder or other person upon refusal to furnish to such corporation or its transfer agent a written statement that such inspection is not desired for purpose (a) and that such stockholder or other person has not been connected with any stock list as provided in (b). Persons so entitled to inspect stock books may make extracts therefrom. No transfer of stock shall be valid as against the corporation, its stockholders and creditors for any purpose except to render the transferee liable for the debts of the corporation to the extent provided for in this chapter until it shall have been entered in such book as required by this section, by an entry showing from and to whom transferred; nor, in the case of domestic stock life insurance corporation until ten days after written notice of such transfer shall have been filed in the office of the superintendent of insurance. Every corporation that shall neglect or refuse to keep or cause to be kept such books, or to keep any stock book open for inspection, as herein required, shall forfeit to the people the sum of fifty dollars for every day it shall so neglect or refuse. If any officer or agent of any such corporation shall willfully neglect or refuse to make any proper entry in such book or books, or shall neglect or refuse to exhibit any such stock book, or to allow any such stock book to be inspected and extracts taken there-

from as provided in this section, the corporation and such officer or agent shall each forfeit and pay to the party injured a penalty of fifty dollars for every such neglect or refusal, and all damages resulting to him therefrom. Nothing herein shall impair the power of the courts to compel the production for examination of the books of a corporation. The stock book and books of account of every stock corporation shall be presumptive evidence of the facts therein so stated in favor of the plaintiff, in any action or proceeding against such corporation or any of its officers, directors or stockholders.

DELAWARE GENERAL CORPORATION LAW

Sec. 29. *Voting List of Stockholders; Preparation; Inspection; Refusal to Produce; Penalty; Voting Powers of Security Holders:*—It shall be the duty of the officer who shall have charge of the stock ledger of a corporation to prepare and make, at least ten days before every election of directors, a complete list of the stockholders entitled to vote at said election, arranged in alphabetical order. Such list shall be open at the place where said election is to be held for said ten days, to the examination of any stockholder, and shall be produced and kept at the time and place of election during the whole time thereof, and subject to the inspection of any stockholder who may be present. Upon the wilful neglect or refusal of the said directors to produce such a list at any election they shall be ineligible to any office at such election. The original or duplicate stock ledger shall be the only evidence as to whom are the stockholders entitled to examine such list or the books of the corporation, or to vote in person or by proxy at such election. The original or duplicate stock ledger containing the name and addresses of the stockholders, and the number of shares held by them, respectively, shall, at all times, during the usual hours for business, be open to the examination of every stockholder at its principal office or place of business in this State, and said original or duplicate stock ledger shall be evidence in all courts of this State.

Every corporation, now or hereafter organized under and pursuant to the provisions of this Chapter, may make suitable provision in its Certificate of Incorporation and thereby to the extent, in the manner and subject to the conditions provided in the Certificate of Incorporation confer upon the holders of any bonds or debentures issued or to be issued by any such corporation, whether secured by mortgage or otherwise, the power to vote in respect to the corporate affairs and management of the corporation to the same extent and in the same manner as stockholders of the said corporation, as may be provided in the Certificate of Incorporation and, in case of a default in the payment of the principal or interest on said bonds or debentures, or otherwise, or in any other case, confer upon such bondholders or debenture holders the same right of inspection of the corporate books and accounts and records of any such corporation, and also any other rights, which the stockholders of the corporation have or may have by reason of the provisions of the Statutes of this State or pursuant to the provisions of the Certificate of Incorporation.

Sec. 30. *Election of Directors; Filling of Vacancies.*—All elections of directors shall be by ballot, unless otherwise provided in the Certifi-

cate of Incorporation. The first meeting for the election of directors at which meeting any business may be transacted shall be held at any place either within or without this State fixed by a majority of the incorporators in a writing signed by them, and thereafter the said directors shall be elected at the time and place within or without this State named in the by-laws, and which shall not be changed within sixty days next before the day on which the election is to be held. A notice of any change shall be given to each stockholder twenty days before the election is held, in person or by letter mailed to his last known postoffice address.

Vacancies shall be filled by a majority of the remaining directors, though less than a quorum, unless it is otherwise provided in the Certificate of Incorporation or the by-laws and the directors so chosen shall hold office until the next annual election and until their successors shall be duly elected and qualified, unless sooner displaced; provided, however, that, if the remaining directors shall constitute less than a majority of the whole Board, upon application of any stockholder or stockholders holding at least ten per cent (10%) of the total number of shares of the capital stock of the corporation at the time outstanding having the right to vote for directors, the Chancellor may in his discretion, summarily order an election to be held to fill any such vacancy or vacancies or to replace the director or directors chosen by the remaining directors as aforesaid, which election shall be governed by the provisions of Section 31 of this Chapter in so far as such provisions are applicable. The person or persons elected pursuant to said order shall serve as a director or as directors until the next annual meeting of stockholders and until their successors shall have been duly elected and qualified, and shall displace any person or persons who may theretofore have been appointed by the remaining directors as aforesaid.

STATE ex rel. GRISMER et al. v. MERGER MINES CORPORATION et al.

Supreme Court of Washington, 1940. 3 Wash.2d 417, 101 P.2d 308.

Mandamus proceeding by the State, on the relation of J. V. Grismer and others, against the Merger Mines Corporation, a corporation, and others. From a judgment for the plaintiffs, defendants appeal. Affirmed.

ROBINSON, JUSTICE. The Merger Mines Corporation is organized under the laws of Arizona. It is authorized to do business in this state, and has a registered office in the city of Spokane. The respondents are shareholders. This action was instituted upon their relation for the purpose of obtaining an inspection of the books and records of the corporation, including the share register or list of shareholders. The complaint alleged that proper demand for such inspection had been made upon the officers of the corporation, and that such demand had been refused. The appellants, in their answer, admitted that the respondents were shareholders of the corporation, and that a demand for an inspection of the books and records of the corporation had been

made. They admitted that they had refused to allow an inspection of the share register or list of shareholders, and alleged, by way of an affirmative defense, that an inspection of the share register was sought for the purpose of harassing the corporation, stirring up strife among the shareholders, and bringing about a change in the management. * * *

Appellants' first contention is that "no proper proof was made of the laws of the State of Arizona governing the right of a stockholder to inspect corporate records as of the date when demand was made herein." The contention is that there is no presumption that the act of 1935 was in force and effect on the date respondents demanded an inspection of the books and records of the corporation. Courts are warranted in reposing confidence in the permanency and stability of the laws of a sister state, to the extent that, when a statute is proven to have existed, it will be assumed to remain in force in the absence of evidence showing its repeal. (Citing cases)

But even if the statute has been repealed, the common law right of a stockholder to examine the books and records of the corporation at proper times and for proper purposes remains. State ex rel. Weinberg v. Pacific Brewing & Malting Co., 21 Wash. 451, 58 P. 584, 47 L.R.A. 208; Guthrie v. Harkness, 199 U.S. 148, 26 S.Ct. 4, 50 L.Ed. 130, 4 Ann.Cas. 433. And, under the common law rule, as it prevails in most states, and under statutes similar to the Arizona statute, the burden of showing improper motives on the part of the shareholder in demanding an inspection of the books and records of the corporation is upon the defendant. It is presumed, until the contrary is shown, that the shareholder seeks the information for a proper purpose. [Citing cases.]

* * * As illustrative of this type of case, see State ex rel. Boldt v. St. Cloud Milk Producers' Ass'n, 200 Minn. 1, 273 N.W. 603; Soreno Hotel Co. v. State ex rel. Otis Elevator Co., 107 Fla. 195, 144 So. 339.

It is also the rule that the books and records of the corporation which the shareholder is entitled to inspect include the share register or list of shareholders. [Citing cases.]

It may well be doubted whether, under the weight of authority, proof of the affirmative matter set up in the answer in this case would have barred the relief asked. State ex rel. Beaty v. Guarantee Mfg. Co., 103 Wash. 151, 174 P. 459. In the complete absence of such proof, the respondents were unquestionably entitled to the writ.

The judgment of the trial court is affirmed.

DAVIDS et al. v. SILLCOX et al.

Supreme Court of New York, Special Term, 1946. 188 Misc. 45, 66 N.Y.S.2d 508.

Proceedings under the Civil Practice Act, § 1283 et seq., by Nancy Davids and another against Luise M. Sillcox as executive Secretary of the Authors' Guild of the Authors' League of America, Incorporated, and another for an order compelling respondents to permit petitioners to inspect the Guild's list of members and the minutes of the meeting for the preceding year, of the Guild's governing body.

Application granted in accordance with opinion.

SHIENTAG, JUSTICE. The respondent Authors' Guild is a division of the Authors' League of America, a membership corporation. The petitioners are members. Proceeding under Article 78 of the Civil Practice Act, the petitioners seek an order compelling respondents to permit them to inspect the Guild's list of members and the minutes of the meetings for the preceding year, of the Guild's governing body.

The Authors' League of America was incorporated in 1912 "to protect the rights and property of all authors". The membership was divided into four "Guilds", of which respondent is one, which operate to some degree autonomously. The respondent has over two thousand members. The direction of its affairs is in the hands of a Council, which consists of thirty members elected at the respondent's annual meeting. Special meetings may be called at the direction of the Council or upon the written request of fifty members.

Petitioners belong to a group of members which is dissatisfied with the conduct of the Guild's affairs. Calling itself "The Committee for Action in the Authors' Guild," this group urges the adoption of a uniform author-publisher contract which would provide for the leasing rather than the outright sale of the book and subsidiary rights, the establishment of basic minimum terms with respect to magazine articles, and the attainment of certain other objectives which the group regards as desirable. The respondent asserts that in so far as these objectives are in the interests of the membership, either they have already been attained, or efforts toward their attainment are in progress.

The application assigns as reasons for the requested relief that the petitioners wish to be informed of the activities of the Council during the preceding year, and to discuss the Council's actions with other members of the Guild. The annual membership meeting, petitioners assert, is inadequate for this purpose, since the membership is large and geographically diffuse. They say that the information sent out by the Council is incomplete; that the membership does not know who attends particular meetings of the Council and who votes for and against particular proposals. They have asked the respondents for copies of the minutes and the membership list, but their request has been rejected. They assert that the usual recourse in a representative organization—the election of new officers—is denied them because of their inability to address their arguments to their unknown fellow-members.

The answer of the respondents denies certain allegations of the petition, and sets up objections in point of law and certain affirmative defenses.

The first affirmative defense alleges that with respect to the petitioners' plan to set up regional chapters and to hold quarterly membership meetings, a similar proposal was transmitted to the membership, upon the petitioners' urging, and the proposal was overwhelmingly defeated. The petitioners reply that in presenting the proposal the Council heavily censored the arguments in support thereof.

The second affirmative defense alleges that publicity would be ruinous to the Guild's plans to improve contracts with publishers, and that a revelation to the membership of the discussions and actions

at Council meetings would inevitably lead to a disclosure to publishers. At such meetings, it is stated, "charges are sometimes heard; complaints, criticisms and disclosures made; plagiarism accusations discussed; on occasion specific inquiries involving pending negotiations between authors and named publishers or others are in consideration." The petitioners reply that the alleged anxiety lest publishers receive confidential information is "strange" in view of the fact that until recently one of the members of the Council was himself an editor of an important magazine. Respondents' affidavit in rebuttal defends the integrity of this individual but does not deny his position.

The third defense alleges that the membership is kept informed of the affairs of the Council, contrary to petitioners' averments, by the circulation of an "Authors' League Bulletin". This defense also alleges that the Council has taken action on the petitioners' request for a membership list and inspection of the minutes, and has determined that the granting of such requests would be detrimental to the membership. * * *

Petitioners reply that the information in the Authors' League Bulletin is inadequate; that many professional organizations have no hesitancy in disclosing their membership rolls; that publicly distributed directories list persons by occupations, and that "If any assurance were needed, petitioners would not hesitate to assure this court that they have no intention of distributing any membership list to any commercial organization for purposes not germane to the affairs of the Guild." * * *

The fourth defense states that the dissident group to which petitioners belong proposed a separate slate of candidates in the elections of 1945; that argumentative matter in support of these candidates was sent out with the ballots, and that the slate was defeated. The respondents refer to a by-law adopted by the Council in September, 1946, governing the transmission of material to members. The by-law provides that no membership list shall be furnished without specific authorization from the Council, and that, at the request of fifty members, the Secretary shall mail to the membership material dealing with any matter "upon which a mail vote is pending". The petitioners assert that the procedure set up is altogether inadequate because of the limitation to matters presented for vote, and charge that the by-law was specifically designed to foreclose the relief which petitioners seek.

The fifth defense points out that any fifteen members of the Guild may nominate candidates and refers again to the petitioners' unsuccessful effort to win an election, emphasizing the opportunity afforded to the petitioners to send out campaign material with the ballots. The petitioners reply that a single mailing of material cannot substitute for a full and free exchange of information.

The questions presented to the court, broadly stated, are whether the court has power to direct the desired inspection in cases of this type, and, assuming the power, whether and how the court's discretion should be exercised in this particular case.

The courts of this state have many times held, in connection with stock corporations, that there is an inherent power, apart from and

unaffected by particular statutory provisions, to order a disclosure of corporate books and records to a petitioning stockholder. No valid distinction can be made on the ground that a membership corporation rather than a stock corporation is involved. While counsel have not brought to the court's attention any case dealing with an inspection of the books and records of a membership corporation, the power of mandamus, from which the power to issue an order of this type under Article 78 is derived, is not limited to stock corporations. In the leading case on this general subject (Matter of Steinway, 159 N.Y. 250, 258, 53 N.E. 1103, 1105, 45 L.R.A. 461), the Court of Appeals, after a careful historical review of the jurisdiction of the Supreme Court, stated: "The right of a corporator, who has an interest, in common with the other corporators, to inspect the books and records of the corporation, for a proper purpose and under reasonable circumstances, was recognized by the courts of King's bench and chancery from an early day, and enforced by motion or mandamus, but always with caution, so as to prevent abuse." * * *

The respondents cite Section 26 of the Membership Corporations Law, stating that the petitioners seek their relief under that section and that none of the situations specified in that section is present here. However, the petition is not based on that section nor are the petitioners' rights limited by its provisions. Although the term "visitation" is applied both to the power to order inspection and to the power contemplated in Section 26, it is clear that something quite different from what is sought here is dealt with in that section. The statute is directed to situations where it is shown that the corporation has been mismanaged; the power of mandamus to compel disclosure goes beyond the field of mismanagement (Durr v. Paragon Trading Corporation, 270 N.Y. 464, 1 N.E.2d 967), and the enactment of this statute cannot be deemed to have extinguished the inherent power. Cf. Matter of Steinway, 159 N.Y. 250, 53 N.E. 1103, 45 L.R.A. 461. The power, then, exists; there is no doubt, however, that it is a discretionary one. [Citing cases.] The standard which governs the exercise of the court's discretion is easily stated. Ordinarily, the court will direct a corporation to open its books and records to its members if the purpose for which inspection is sought appears to be a proper one. However, as the cases cited above show, the order of inspection will by no means issue perfunctorily upon the mere statement of a purpose which appears to be proper, and its issuance may be subject to such limitations and safeguards as the circumstances require. The blackmailer, the scandalmonger, the irresponsible busybody and trouble maker, the professed seeker of information which is really intended to be used for some ulterior purpose, will be given no consideration by the court.

The propriety of petitioners' purpose is revealed by respondent, although, paradoxically, the revelation is made as part of an argument in opposition. Much of what respondent has to say against the application is summarized in the concluding sentence of its brief, which states: "It is clear that the undisclosed purpose of the group is to attack the governing body, * * *." This purpose is neither undisclosed nor improper. A distinction must be made between an attempt

to subvert an organization and an attempt to impugn or to replace its present leadership. The former, of course, could not furnish the basis for the issuance of the writ; the corporation obviously should not be compelled to aid in its own harm or destruction. But it is the interests of the corporation, and not those of the group which holds power within the corporation, which the court must protect. The amendment of a corporation's procedures and the replacement of its present officers are legitimate objectives for members of the corporation. The petitioners' projects, in aid of which they seek the disclosure, are directed toward what they conceive to be the interests of the membership. It is not for the court to say how well they are adapted toward that end, or whether the petitioners' or the respondents' program is better for the members of the corporation. Respondents' papers contain no averment that petitioners seek the disclosure for some purpose other than those described above. Accordingly, there is no triable issue of fact as to the propriety of the petitioners' purpose.

The purpose being proper, are there any considerations which require that the application be denied? The respondents urge that disclosure of the names and addresses of the members would be dangerous. The dangers do not seem to me to be serious enough to deny to the petitioners the access which they might otherwise have. The problems peculiar to a stock corporation (where the right to lists of shareholders and bondholders is governed by statute) are not present here; we are not faced with the risk that a list of security-holders may be used by those having knowledge which the scattered investors lack, to the detriment of those investors and to the profit of those possessing the list. The only concrete danger which respondents set forth is that the list would have "a high financial value to organizations whose business it is to sell lists 'of prospects' in various fields of business endeavor." This danger cannot be regarded as a serious one. Nor can the fact that various members have requested that their addresses be kept confidential be given weight on this application. Section 46 of the Membership Corporations Law provides that the directors of a membership corporation shall present at its annual meeting a report which includes, among other things, the names and addresses of all persons who have become members of the corporation during the preceding year. If this provision is complied with, a complete membership list is available to any member who attends all the yearly meetings. Since the statute contemplates this degree of publicity, the court cannot say that there are reasons for keeping the membership list secret which must outweigh the considerations in favor of disclosure.

However, the order will enjoin the use of the list for any purposes other than those related to Guild affairs. There may be situations where, instead of ordering access to the list of the names and addresses of members, it would suffice to direct the mailing to the membership at large of material prepared by objecting members. Here, however, such an expedient would not serve petitioners' legitimate purposes. The expense of copying the list of members and their addresses must, of course, be borne by the petitioners.

Respondents' objections to disclosing the minutes of the Council meetings are more substantial, for the potentialities of harm described by the respondents are real. The discussions at Council meetings may well involve matters which, from the point of view of the general membership, should be kept confidential. No case has been cited by counsel dealing with an inspection of minutes of the executive board of a corporation. While the mandamus power undoubtedly extends to all corporate books and records (see Brentmore Estates, Inc., v. Hotel Barbizon, 263 App.Div. 389, 394, 33 N.Y.S.2d 331, 336) a wise discretion may dictate that certain records are to be more jealously guarded than others. Included in the category of records which the courts should be slow to open are records of the deliberations of the governing bodies of organizations whose activities include arm's-length negotiations with outsiders.

However, the principal object of the petitioners in this regard—information concerning the past activities of the Council—can be substantially accomplished without disclosing the confidential discussions or transactions which respondents urge should be kept secret. This can be done by limiting the disclosure to the dates of the meetings, the names of those present, the subjects that were taken up, and the formal resolutions and action taken at each meeting. The respondents will not be required to disclose minutes of proposals, discussions or negotiations, nor will they be required to disclose resolutions dealing entirely with the action taken in matters limited in scope to the affairs of individual members of the organization. These limitations are imposed, not in the interests of the present governing officials, but in the interests of the membership as a whole. If there is any substantial difficulty concerning the scope of the inspection of the minutes, as above limited, the order to be settled may provide that the inspection take place under the supervision of a referee to be appointed by the court.

Certain of respondents' objections not specifically dealt with above may be referred to briefly. The petitioners' legitimate purposes being proved, it does not matter that the petition charges no bad faith, malice or violation of organization rules. The various arguments based on the court's unwillingness to interfere with the management of corporations, and cases such as City Bank Farmers' Trust Co. v. Hewitt Realty Co., 257 N.Y. 62, 177 N.E. 309, 76 A.L.R. 881, Flynn v. Brooklyn City R. Co., 158 N.Y. 493, 53 N.E. 520, and Van Campen v. Olean General Hospital, 210 App.Div. 204, 205 N.Y.S. 554, have no bearing on the present issue. The Council's decision not to accede to the petitioners' request cannot be regarded as a matter of internal management within the meaning of those cases. If it were to be so regarded, every attempt to inspect corporate records, except where the petitioner could show fraud or bad faith, could be forestalled by the simple device of passing a resolution. The "clear legal right" which the decisions mention is established, as the cases cited earlier in the opinion demonstrate, when a member seeks inspection for a proper purpose. The petitioners have "substantial property rights" in whose aid the court's processes may be invoked, as do the members of a union in an

analogous situation. Cf. Dusing v. Nuzzo, 177 Misc. 35, 29 N.Y.S.2d 882.

On the papers before me, it is not questioned that the petitioners are members of the Guild. The disclosure they seek is in connection with plans designed—whether well or poorly designed is immaterial—for the benefit of the corporation. The petitioners' application is granted; the disclosure will be limited, however, in the manner described above, in accordance with what appears to be the best interests of the membership.

The disclosure, despite all safeguards, may result in some inconvenience; the possibility that harm may ensue cannot be entirely avoided. But these risks are, in the present case, greatly outweighed by the benefits to be derived from a more democratic form of procedure that will give all members information as to how their organization is being managed and afford the opportunity to place their views as to its conduct before their fellow members.

Settle order in accordance with the foregoing determination.[4]

3. RIGHT TO INFORMATION

NEW YORK STOCK CORPORATION LAW

§ 77. *Financial statement to stockholders.* Stockholders owning three per centum of the shares of any corporation other than a moneyed corporation may make a written request to the treasurer or other fiscal officer thereof for a statement of its affairs, under oath, embracing a particular account of all its assets and liabilities, and the treasurer shall make such statement and deliver it to the person making the request within thirty days thereafter, and keep on file in the office of the corporation for twelve months thereafter a copy of such statement, which shall at all times during business hours be exhibited to any stockholder demanding an examination thereof; but the treasurer shall not be required to deliver more than one such statement in any one year. The supreme court, or any justice thereof, may upon application, for good cause shown, extend the time for making and delivering such statement. For every neglect or refusal to comply with the provisions of this section the corporation shall forfeit and pay to the person making such request the sum of fifty dollars, and the further sum of ten dollars for every twenty-four hours thereafter until such statement shall be furnished.

SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C.A. § 78m

PERIODICAL AND OTHER REPORTS

Sec. 13. (a) Every issuer of a security registered on a national securities exchange shall file the information, documents, and reports below specified with the exchange (and shall file with the Commission

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4 Reversed by the Appellate Division, per curiam 3–2; 272 App.Div. 54, 69 N.Y.S. 2d 63, 1947, on the basis of a Guild by-law which provided that a list of members should not be furnished to anyone without the authorization of the Guild Council.

such duplicate originals thereof as the Commission may require), in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security—

(1) Such information and documents as the Commission may require to keep reasonably current the information and documents filed pursuant to section 12.

(2) Such annual reports, certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports, as the Commission may prescribe.

(b) The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; but in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter, and, in the case of carriers subject to the provisions of section 20 of the Interstate Commerce Act, as amended, or carriers required pursuant to any other Act of Congress to make reports of the same general character as those required under such section 20, shall permit such carriers to file with the Commission and the exchange duplicate copies of the reports and other documents filed with the Interstate Commerce Commission, or with the governmental authority administering such other Act of Congress, in lieu of the reports, information and documents required under this section and section 12 in respect of the same subject matter.

(c) If in the judgment of the Commission any report required under subsection (a) is inapplicable to any specified class or classes of issuers, the Commission shall require in lieu thereof of the submission of such reports of comparable character as it may deem applicable to such class or classes of issuers.

GUTHRIE v. HARKNESS.

Supreme Court of the United States, 1905. 199 U.S. 148, 26 S.Ct. 4.

The defendant in error was the owner of nearly one-fifth of the capital stock of the Commercial National Bank of Ogden, Utah. As such shareholder he applied for leave to inspect the books, accounts and loans of the bank, which was refused him. He alleges the reasons

for seeking such inspection to be that he might ascertain the value of his stock in the bank and whether the business affairs of the same had been conducted according to law. He charges that loans had been made to patrons of the bank of more than one-tenth of the capital stock in violation of law, and that an inspection of the books, accounts and loans of the bank would reveal other irregularities. * * *

MR. JUSTICE DAY, * * * There can be no question that the decisive weight of American authority recognizes the common law right of the shareholder, for proper purposes and under reasonable regulations as to place and time, to inspect the books of the corporation of which he is a member. Morawetz in his work on Corporations, section 473, says:

"However, in the United States the prevailing doctrine appears to be that the individual shareholders in a corporation have the same right as the members of an ordinary partnership to examine their company's books, although they have no power to interfere with the management." * * *

The right of inspection rests upon the proposition that those in charge of the corporation are merely the agents of the stockholders who are the real owners of the property. Cincinnati Volksblatt Co. v. Hoffmeister, 62 Ohio St. 189, 201, 56 N.E. 1033.

It is suggested in argument that if the shareholder has this right it may be abused, in that he may make an improper use of the knowledge thus gained. There is nothing in this record, however, to suggest, by way of argument or testimony, that the shareholder desired the information which the books would give for other than a lawful purpose. On the other hand, there is a distinct finding that the inspection was desired for the purpose of ascertaining the true financial condition of the bank and for the purpose of enabling the complainant to find out the value of his stock, and whether its business was being conducted according to law. There is no suggestion that the complainant was acting in bad faith or from improper motives, or that he was seeking in any way to misuse the information which the books would afford him. We need not hold that there may not be circumstances which would justify the courts in withholding relief to a stockholder seeking an examination of the books and accounts of the bank. In the case before us no reason is shown for denying to the stockholder the right to know how his agents are conducting the affairs of a concern of which he is part owner. Many legal rights may be the subjects of abuse, but cannot be denied for that reason. A director, who has the right to an examination of the books, may abuse the confidence reposed in him. Certainly this possibility will not be held to justify a denial of legal right, if such right exists in the shareholder. The possibility of the abuse of a legal right affords no ground for its denial. State ex rel. Doyle v. Laughlin, 53 Mo.App. 542, supra; People v. Goldstein, 37 App.Div.N.Y. 550, 56 N.Y.S. 306. The text books are to the same effect as the decided cases. Cook on Stock and Stockholders, sec. 511; Boone on Law of Banking, sec. 235; Angel & Ames on Corporations, 607.

It does not follow that the courts will compel the inspection of the bank's books under all circumstances. In issuing the writ of mandamus the court will exercise a sound discretion and grant the right under proper safeguards to protect the interests of all concerned. The writ should not be granted for speculative purposes or to gratify idle curiosity or to aid a blackmailer, but it may not be denied to the stockholder who seeks the information for legitimate purposes. In re Steinway, 159 N.Y. 250, 53 N.E. 1103; Thompson on Corporations, § 4412 et seq. * * *

Finding nothing in the act of Congress limiting the common law right of the shareholder, we think that, under the circumstances of this case, he was wrongfully denied an inspection of the books and accounts of the bank by its officers, and the judgment of the Supreme Court of Utah is affirmed.

ALBEE v. LAMSON & HUBBARD CORPORATION et al.

Supreme Judicial Court of Massachusetts, 1946. 69 N.E.2d 811.

Proceeding by Arthur L. Albee for a writ of mandamus to compel the Lamson & Hubbard Corporation and another to permit petitioner to examine certain records, accounts, and documents of respondent corporation. Order to allow examination of certain classes of records, books, and documents, and respondents bring exceptions.

Exceptions sustained.

RONAN, JUSTICE. The respondents have excepted to an order requiring them to permit the petitioner, a stockholder in the respondent corporation, to examine certain corporate records, accounts and documents. The bill of exceptions states that the case came on to be heard on the petition and answer, and that the judge entered an order which, after stating that "it was agreed" by the respondents that "the facts were as set forth in the petition," ordered the respondents to allow an examination of four different classes of records, books and documents.

The petition for a writ of mandamus alleged that the petitioner was a stockholder in the respondent corporation; that he had made a demand for the examination of certain books and records; and that such demand had been refused. These allegations were admitted by the respondents' answer, which further alleged that the petitioner had brought a bill in equity against the respondent corporation and others, the pleadings in which were made a part of the answer. The answer also alleged that the petition was brought in aid of the said bill in equity; that the petitioner had a plain and adequate remedy in the equity suit to enforce his right of inspection of the corporate books and records; that the petition for a writ of mandamus was intended to oppress and harass the respondents and was unnecessary; and that the petitioner was barred by laches from maintaining the petition. * * *

Our inquiry is whether on the facts alleged and admitted the petitioner was entitled to prevail. At the outset it must be observed that the petitioner is not seeking to enforce any statutory right of examination of the books and records specified in G.L.(Ter.Ed.) c. 155, § 22, and no such statutory right is involved in the present case. See Powel-

son v. Tennessee Eastern Electric Co., 220 Mass. 380, 107 N.E. 997, Ann.Cas.1917A, 102; Shea v. Parker, 234 Mass. 592, 126 N.E. 47.

The common law right of a stockholder to examine the books and accounts of the corporation is not an absolute right but is a qualified one. Stockholders are the beneficial owners of all the assets of the corporation, and they are entitled to reliable information as to the financial condition of the corporation, the manner in which its business has been conducted and its affairs have been managed, and whether those to whom they have entrusted their property have acted faithfully and efficiently in the interests of the corporation. A stockholder who is acting in good faith for the purpose of advancing the interests of the corporation and protecting his own interest as a stockholder is generally entitled to examine the corporate records and accounts. But he has no such right to an examination if his purpose be to satisfy his curiosity, to annoy or harass the corporation, or to accomplish some object hostile to the corporation or detrimental to its interests. [Citing cases.]

The burden of proof was upon the petitioner to allege and prove his good faith and a proper purpose. His right being a qualified one, he fails if his petition and proof are insufficient to bring his case within the limitations of his common law right. There was error in ordering the writ to issue, where, as here, all that appeared was that the petitioner was a stockholder and that his demand for an examination of certain books, records and documents had been denied. [Citing cases.]

Exceptions sustained.

SLAY v. POLONIA PUBLISHING COMPANY.

Supreme Court of Michigan, 1930. 249 Mich. 609, 229 N.W. 434.

Action by Louis C. Slay against the Polonia Publishing Co. Judgment for plaintiff, and defendant brings certiorari.

Reversed, and petition dismissed.

SHARPE, J. Plaintiff, the owner of one share of stock in the defendant company, petitioned for mandamus to compel its officers to permit him to inspect and examine the books and statements of the corporation. Defendant seeks review by certiorari of the order of the trial court granting the writ.

Plaintiff's right thereto is based upon the following provision in section 11 of chapter 1 of part 2 of Act No. 84, Pub. Acts 1921:

"The books of every corporation containing its accounts shall be kept, and shall at all reasonable times be open in the city, village or town where such corporation is located, or at the office of the treasurer of such corporation within this state, for inspection by any of the stockholders of said corporation, and said stockholders shall have access to the books and statements of said corporation and shall have the right to examine the same in the said city, village or town or at said office."

Before its enactment, this court had held that, under the common law, a stockholder in a corporation had the right in a proper case, and for a proper purpose, to inspect the corporate records. Woodworth v.

Old Second Natl. Bank, 154 Mich. 459, 117 N.W. 893, 118 N.W. 581; Eldred v. Elliott, 161 Mich. 262, 126 N.W. 219. But such right was a qualified, and not an absolute one. The duty devolved upon the stockholder to make it appear to the officers that he was actuated by motives that were lawful and proper, and that his purpose in securing the information was to subserve the interests of the corporation or his personal interest as a holder of corporate stock.

The provision in the statute above quoted contains no such limitation. This court must assume that the Legislature was aware of the rights of the stockholder under the common law, and that its purpose in including this provision in the Corporation Act was to make some change therein. It cannot be said to be merely declaratory of the common law, for the reason that it omits the requirement in that law as to the duty devolving on the stockholder, as above stated, when making his request.

It is to be assumed that the request is made for a proper purpose; that the stockholder is acting in good faith, and seeking thereby to protect his own interest or that of the corporation, and therefore his request therefor need not be accompanied by any statement of his purpose. The statute accords the right to him, and he is entitled to the privilege for the asking. See notes in 22 A.L.R. 24; 43 A.L.R. 783.

Thus far it may fairly be said there is substantial uniformity in the holdings of the courts. But, when his request is denied, and he seeks mandatory relief, and the answer of the corporation sets up facts from which it appears that his purpose is not as above stated, but is inimical to the best interests of the corporation and its other stockholders, and these facts are conceded, or established by proofs, the authorities are much at variance as to the duty of the court to issue the writ.

The Supreme Court of Wisconsin (State ex rel. Dempsey v. Werra Aluminum Foundry Co., 173 Wis. 651, 182 N.W. 354, 22 A.L.R. 1) has held that the writ will issue as a matter of course, but intimates that the stockholder may be prevented from using the information thus secured for an unlawful purpose. In Johnson v. Langdon, 135 Cal. 624, 67 P. 1050, 1052, 87 Am.St.Rep. 156, the right of the stockholder is held to be absolute, and that he cannot "be met with the defense that his motives are improper." In Wilson v. Mackinaw State Bank, 217 Ill.App. 494, it was said that the right was absolute, and did not depend upon any circumstance or condition except the ownership of stock. There are other decisions of similar import, although later cases in some of the same courts qualify the language used.

But the great weight of authority sustains the rule that, while the right given by the statute is absolute, mandamus is a discretionary writ, which will not be issued to enforce such right except for a just cause and a proper purpose. * * *

Mandamus is the proper remedy of a stockholder to secure such right. Leach v. Davy, 199 Mich. 378, 165 N.W. 927. It is "not a writ of right * * * and will not issue to compel an unlawful act, or to work an injustice." Johnson v. Board of Supervisors, 202 Mich. 597, 600, 168 N.W. 421, 422. The question presented, then, is this, Under the facts appearing in this record, was the plaintiff entitled to the writ?

The defendant in its answer to the order to show cause, verified by its vice president and general manager, averred that the real owner of the share of stock assigned to plaintiff was one Louis Wojcik. The seventh paragraph thereof reads as follows:

"That as to the matters alleged in paragraph seven of said petition, this respondent says that one, Louis Wojcik, is, and has been for some time past, the principal owner and the editor of the Polish Daily News, the sole competitor of this respondent in publishing a Polish daily newspaper in the city of Detroit. That the said Louis Wojcik has interviewed numerous of the advertisers, whose advertisements appear in the issues of this respondent's paper, and falsely stated to them that this respondent did not have the circulation it claimed to have; that it was losing money and it would only be a matter of time when he, the said Louis Wojcik, would own this respondent or put it out of business; and that they, the advertisers, were foolish in wasting their time in advertising in respondent's paper, and made divers and false statements relative to this respondent corporation, to its paper, and to its business, and made threats to divers persons that he would ruin this respondent, and, as a part of his scheme so to do, this respondent shows that in the month of June or July in the year 1927, he induced one, Anthony Glowczewski, to buy one share of this respondent's capital stock, and to that end the said Anthony Glowczewski approached one, Dr. Lazowski, and purchased from the said Dr. Lazowski one share of stock, and that the consideration therefor was paid to the said Anthony Glowczewski by the said Louis Wojcik.

"This respondent further shows that the said Louis C. Slay, alleged petitioner herein, was and is an employee of the said Louis Wojcik, and has been associated with him in business for some years in the Detroit Commerce Corporation and in other enterprises; and avers and charges the truth to be, that the said Louis C. Slay is merely a figurehead for the said Louis Wojcik, and that the said Louis Wojcik is desirous of obtaining the information sought by the said Louis C. Slay for the purpose of using the same against the best interests of this respondent and of the stockholders, and of distorting the information obtained thereby for the purpose of unfair competition with this respondent and with its business, and for the purpose of attempting to cripple this respondent and its stockholders, and that the information sought by this alleged petitioner is not sought in good faith, nor for the personal use of said petitioner, and that the furnishing of such information would be detrimental to the interests of all the stockholders of this respondent, but, as aforesaid, it is merely a blind to obtain such information to use in an unjust and unfair attempt to injure and damage this respondent and its stockholders."

At the opening of the hearing, counsel for the defendant said: "If the relator is willing to make it the sole issue, that is, that the motive for the obtainance of information is not relevant to the issue and that he has a right of inspection irrespective of motives or desires; then I am willing to proceed. If he is willing to admit that it does not make any difference what a man's motives are, but that he has a right to inspect the books irrespective of any ulterior or improper motives."

After some discussion, he further said: "Your proposition is that no matter how detrimental to the Polonia Publishing Company your desire may be, it is absolutely material (immaterial)." To which counsel for the plaintiff replied: "Absolute, unless it appears we are going to perpetrate a criminal act."

We must therefore accept the statements in the answer above quoted as expressive of the purpose of the plaintiff in seeking the inspection. It needs no analysis of the language used to conclude that such purpose was entirely foreign to his status as a stockholder, that the privilege of inspection by him was not sought in good faith for the protection of the interests of the corporation, or of his own interest as a stockholder, and that he was not entitled to the writ.

The order is reversed and set aside, and the petition dismissed, with costs to appellant.

TATE v. SONOTONE CORPORATION et al.

Supreme Court of New York, Appellate Division, First Department, 1947.
272 App.Div. 103, 69 N.Y.S.2d 535.

Proceeding in the matter of the application of Bertram B. Tate against Sonotone Corporation and others, for an order, under article 78 of the Civil Practice Act directing defendants to permit petitioner to inspect the stock book of defendant corporation. From an order for petitioner, defendants appeal.

Reversed and motion denied.

PER CURIAM. The order below authorizes petitioner to inspect and make extracts from the stock book of appellant Sonotone Corporation as a stockholder under section 10 of the Stock Corporation Law. The proceeding is in the nature of mandamus under art. 78 of the Civil Practice Act. "While Section 10 of the Stock Corporation Law gives stockholders the right to inspect the stock book of a corporation, the court may consider the purpose of such an examination on an application for an order under Article 78 of the Civil Practice Act, and may, in its discretion, deny such an application where the purpose is not consonant with law, the business of the corporation or good faith. Matter of Coombs v. Edwards, 280 N.Y. 361, 364, 21 N.E.2d 353, 354; Matter of Durr v. Paragon Trading Corp., 270 N.Y. 464, 469, 1 N.E. 2d 967, 969." Baker v. Macfadden Publications, Inc., 270 App.Div. 440, 443, 59 N.Y.S.2d 841, 844. That is similar to the common law rule (Matter of Steinway, 159 N.Y. 250, 53 N.E. 1103, 45 L.R.A. 461) and, although it has sometimes been stated that the right of inspection under what is now section 10 of the Stock Corporation Law is absolute (Henry v. Babcock & Wilcox Co., 196 N.Y. 302, 89 N.E. 942, 134 Am.St.Rep. 835), "during the last few years, especially, the principle that the stockholder's bad faith and improper purposes or motives constitute a bar to the judicial enforcement of the right of inspection has received new support. As said in one late case, 'the trend, however, is toward a reversion to the common-law rule, which makes motive and good faith material in an application for inspection.' In some of the states where the courts originally took the position that the positive

terms of the statute were mandatory with respect to the granting of mandamus to enforce the right, as well as to the abstract right itself, that extreme position has been receded from, especially with respect to the remedy, either by the legislature, or by the courts themselves in overruling or limiting their former decisions and adhering to the common-law rule that on application to the courts to enforce the right, a showing of bad faith and improper purpose or motives are sufficient to move the court to exercise its discretion against enforcing the right." (Fletcher: Cyclopedia Corporations, 1931 ed., Vol. 5, sec. 2220; see annotation 59 A.L.R. 1375 et seq.)

It is not intimated that the burden is on the stockholder affirmatively to show his good faith, but where, as here, the papers before the court establish that the purpose of the inspection is unrelated to the welfare of the petitioner as a stockholder, the application should be denied. If the papers before the court disclosed an issue of fact on this subject, an order in the nature of an alternative mandamus would be warranted, but the facts in this record lead only to the conclusion that the application is made in bad faith. That petitioner is not motivated by a desire to aid a competing business has no tendency to establish that he is trying to better his economic position as stockholder where what actuates him is clearly "disinterested malevolence" (American Bank & Trust Co. v. Federal Reserve Bank of Atlanta, Georgia, 256 U.S. 350, 41 S.Ct. 499, 65 L.Ed. 983, 25 A.L.R. 971; Beardsley v. Kilmer, 236 N.Y. 80, 88–90, 140 N.E. 203, 205, 206, 27 A.L.R. 1411) against the individuals in charge of the corporation. * * *

Order reversed with $10 costs and disbursements to the appellants and the motion denied. Settle order on notice.

STATE ex rel. ROGERS v. SHERMAN OIL COMPANY.

Superior Court of Delaware, 1922. 1 W.W.Harr. 570, 117 A. 122.

Mandamus by the State of Delaware, on the relation of Remington Rogers, against the Sherman Oil Company, a corporation organized and existing under the laws of Delaware. Motion to quash return granted in part, and refused in part.

Petition granted against respondent for the purpose of determining the value of relator's stock; refused as to the Gates Oil Company.

PENNEWILL, C. J., delivering the opinion of the court:

This case is before the court on a motion to quash certain parts of respondent's answer or return to the alternative writ.

There are three questions raised by the petition and answer:

(1) The right of the petitioner to inspect the books and papers of the defendant company.

(2) The right to inspect the books and papers of the Gates Oil Company.

(3) The right to make copies of such books and papers.

The right of the petitioner to inspect the books and papers of the Sherman Oil Company, the respondent, is not seriously controverted; indeed, it is granted in the return. But, even if it was not granted

or admitted, the court would feel constrained to concede the right, under the law of this as well as other states.

Where the reason or motive for inspection is a proper one, the court will grant the right to inspect such books and papers of the respondent corporation as may be necessary to furnish the information desired by the petitioner, such right to be exercised at reasonable and proper times and places.

The reason alleged for inspection in this case is to obtain information that will enable the petitioner to ascertain the value of his stock.

The reason alleged seems to be a proper one, and the court are not convinced by anything averred in respondent's return that it is improper, or not made in good faith.

But the respondent insists that it would be unable to allow inspection of the books and papers of the Gates Oil Company because it has neither the possession or control of them.

It is undisputed that the two companies are legally separate and independent entities; that the directors and officers are entirely distinct; that all the books and papers are kept, not only in different offices, but in different states, and far apart. It is averred in the return that the respondent acquired its stock in the Gates Oil Company purely as an investment; that it has had nothing to do with the financing, management or control of said company, which was and is a going concern, having a profitable business and making gains which could be applied to dividends.

While it is alleged in the petition that the respondent has control of the management, books and papers of the Gates Oil Company, it is not claimed that it is not legally a separate and independent corporation, having directors, officers and place of business entirely distinct from the respondent; it is not alleged that there has been any meeting of the stockholders of the Gates Oil Company since the respondent acquired its stock therein in September last, at which the respondent voted, or could have voted its stock and thereby obtained control of the company.

The relator's case is based entirely on the theory that, because the respondent has a largely preponderating amount of the capital stock of the Gates Oil Company, it has the power to produce, for the inspection of one of its share holders, the books and papers of said company.

It may be that, because of the respondent's large interests in the company, it might exert such persuasive power as to secure the production of its books for the relator's inspection, but in this proceeding we are not dealing with possibilities, but only with the legal power or ability of the respondent to comply with the command of the court, if a peremptory writ should be issued as prayed for by the petitioner.

If the power of the respondent to comply with the writ would be lacking, then, under all the authorities, it should not be issued. To entitle the relator to the issuance of the writ, his right to the relief sought must be clear, and the ability of the respondent to grant the relief must sufficiently appear.

It is true, as argued by the relator, that the respondent's return is not to be accepted as true in respect to averments that are conclusions

of law, or that are merely argumentative, but it must be taken to be true as to averments of facts, and the court are of the opinion that from such averments it sufficiently appears that the respondent would not have the legal ability to furnish the relief asked for. The writ is never issued if the court is convinced that it would be unavailing, or that it would be vain and futile for the purpose for which it is sought.

The relator's thought seems to be, that the court may compel the respondent to secure a meeting of the stockholders of the Gates Oil Company, and thereby gain control of the company and furnish for inspection the books and papers desired. It is quite possible that the defendant might be able, by virtue of its stock holdings in said company, to acquire control of it by voting its stock, if a stockholders' meeting were held, but it does not appear that such a meeting has been held since the respondent secured its stock; neither does it appear when or how a meeting could be held under the laws and rules governing the corporation. It is sufficient to say, it is not shown that the respondent was, at the time the petition was filed, is now, or would be if the writ was issued, in a position to comply with its mandate.

So far as the court are informed, this is the first time the question we are now discussing has been distinctly raised in this or any other state. And it so happens that the one case in which a question somewhat analogous to the present one was passed on was in our own state, viz.: Martin v. Martin, 10 Del.Ch. 211, 88 A. 612, 102 A. 373. But that case was different from the one at bar in these particulars: (1) It was in a court of equity where the principles of law are not so controlling as in this court. (2) The companies that were required to produce their books and disclose the information required in connection with the charge of fraudulent mismanagement of corporate affairs, were practically one and the same in so far as management and control were concerned. There were eight companies engaged in the same general business. The president of the respondent company was president of all the allied companies but one, the respondent company owned all the shares of stock of seven of them. All the members of the boards of directors of four of the allied companies were directors of the respondent company, and a majority of the members of the boards of directors of the other four were directors of the respondent company.

It was held that the subsidiary corporations should be regarded by a court of equity as mere instrumentalities of the respondent, and compelled to produce the books of such companies, for discovery, as well as its own.

Certainly a court of equity, under the searching and almost unlimited power it possesses, and its disregard of mere forms, in discovering and revealing fraud, had, under such circumstances the right to compel the production of the books and papers of such companies. The case was different from the one before us, not only because of the character of the court in which it was brought, but also because of the close relations existing between the companies and the identity of management and control. They were not, in fact, independent entities, or separate and distinct, as in the present case.

But, even though the relator has a right to inspect the books, records and papers of the respondent corporation for the purpose of ascertaining the value of his stock, has he the right to make copies thereof?

This question has been considered and passed upon by our own courts, which hold, in conformity with the law laid down by text writers and adjudicated cases elsewhere that:

"The right of a stockholder to make copies, abstracts and memoranda of documents, books and papers is an incident to the right of inspection. * * * The right rests, as does the similar right to examination, upon the broad ground that the business of the corporation is not the business of the officers exclusively, but the business of the stockholders." 4 Fletcher's Enc. of Corporations, 4123, 4124, § 2840; Swift v. Richardson, 7 Houst. 338, 6 A. 856, 32 A. 143, 40 Am.St.Rep. 127; State v. Jessup & Moore Paper Co., 1 Boyce, 379, 398, 77 A. 16, 30 L.R.A.,N.S., 290; State v. Jessup & Moore Paper Co., 3 Boyce, 329, 331, 83 A. 30.

In the last-cited case, it was held that a stockholder has the right to inspect and make copies of such of the books, papers, accounts and writings of the respondent mentioned in his petition, and only of such of them, that are found essential and sufficient to furnish the information whereby the relator may determine the value of his stock.

The court hold in the present case that the relator is entitled to inspect and make copies of such of the books, records and papers of the respondent company, mentioned in his petition, that are essential and sufficient to furnish the information whereby the relator may determine the value of his stock, and that a peremptory writ should be issued for that purpose; but also hold that such writ should not be issued against the respondent company commanding it to permit the relator to inspect and make copies of the books, records and papers of the Gates Oil Company.

The relator's motion to quash the return of respondent is accordingly granted in part and refused in part.

4. STOCKHOLDERS AGREEMENTS AS TO VOTING

(a) Not To Alienate His Vote

PALMBAUM v. MAGULSKY.

Supreme Judicial Court of Massachusetts, 1914. 217 Mass. 306, 104 N.E. 746.

Action by Joseph Palmbaum against Abraham M. Magulsky. There was a verdict for defendant, and plaintiff brings exceptions. Sustained, and judgment entered for plaintiff.

CROSBY, J. This is an action of contract upon a promissory note executed and delivered by the defendant to the plaintiff for money advanced by him (the plaintiff) to the defendant, with which he (the defendant) purchased certain shares of stock in a corporation known as the American Biscuit Company, in which the plaintiff and one Hoffman were also shareholders. The stock so purchased by the defendant was held by the plaintiff by assignment to secure the payment of the note. It appeared at the trial that about two years after the note was given the defendant agreed with the plaintiff, in consideration of the plaintiff's surrendering the note, to attend a stockholders' meeting of

the corporation and vote with the plaintiff to dispose of all the assets of the corporation which, according to the report, amounted to several thousand dollars. Among other defenses in his answer and amended answer, the defendant alleged that he had performed his part of the foregoing agreement. The exceptions set forth substantially all the evidence introduced at the trial, from which it appears that the defendant is liable upon the note, unless his performance of the agreement is a valid defense.

The defendant testified to the making of the agreement and that he had carried out his part thereof, and offered other evidence to the same effect. There was no evidence that the only other stockholder, Hoffman, assented to the agreement or had any knowledge of it.

At the close of the evidence the plaintiff requested the court to make nine rulings, the sixth, seventh, eighth, and ninth of which were given. The second request was waived. The third was covered substantially by the ninth, which was given. The fourth and fifth requests could not have been given in the form presented.

The court instructed the jury that the agreement, if proved, constituted a defense to the action, to which the plaintiff excepted.

In our opinion the court should have ruled that the agreement was not a defense, and should have instructed the jury to return a verdict for the plaintiff in accordance with his first request.

It is the duty of a stockholder of a corporation, in attendance at meetings of the stockholders, to act fairly and in good faith. He is not justified in entering into any agreement to vote so as to perpetrate a fraud upon another stockholder. The defendant's vote to dispose of all the assets of the corporation was in consideration of the surrender of the note to him by the plaintiff. This was illegal, and the agreement was void as against public policy.

As was said by Colt, J., in Guernsey v. Cook, 120 Mass. 501, 502: "It was the purpose and effect of the contract to influence the defendant, in the decision of a question affecting the private rights of others, by considerations foreign to those rights. The promisee was placed under direct inducement to disregard his duties to other members of the corporation, who had a right to demand his disinterested action in the selection of suitable officers. He was in a relation of trust and confidence, which required him to look only to the best interest of the whole, uninfluenced by private gain. The contract operated as a fraud upon his associates." The contract in the case now before us operated as a fraud upon Hoffman.

Where an agreement is made which is either contrary to public policy or fraudulent as to third parties, it will not be enforced, although in the particular instance no injury may have resulted. Gibbs v. Smith, 115 Mass. 592.

In the case of Woodruff v. Wentworth, 133 Mass. 309, this court held that the agreement of a stockholder in a private business corporation, to vote for a certain person as manager, and to vote to increase the salaries of the officers including that of the manager, was void as against public policy, unless it was consented to by all the stockholders of the corporation.

In the case at bar the agreement of the defendant to vote to dispose of all the assets of the corporation without the knowledge or assent of Hoffman was a corrupt bargain and unlawful, and cannot be availed of by him as a defense to the note. See West v. Camden, 135 U.S. 507, 10 S.Ct. 838, 34 L.Ed. 254; Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159, 198, 199, 89 N.E. 193, 40 L.R.A.,N.S., 314; Northwest Transportation Co., Limited, v. Beatty, 12 App.Cas. 589; Costello v. London General Omnibus Co., 107 L.T. 575.

The exceptions should be sustained, and as substantially all the evidence in the case is before us, and as it appears therefrom that there was no defense to the note, judgment should be entered for the plaintiff under St. 1909, c. 236.

So ordered.

STOTT v. STOTT.

Supreme Court of Michigan, 1932. 258 Mich. 547, 242 N.W. 747.

Action by David E. Stott against Arthur F. Stott. From a judgment for plaintiff, defendant appeals.

Affirmed.

POTTER, J. Plaintiff sued defendant declaring on all the common counts in assumpsit, giving notice the cause of action was based upon a promissory note given by defendant to plaintiff December 23, 1925, for $3,460 with interest at 6 per cent. per annum. This promissory note constituted plaintiff's sole bill of particulars. Defendant pleaded the general issue and gave notice that for a valuable consideration plaintiff did release defendant from all liability on the note sued upon. Plaintiff moved for summary judgment. Defendant filed an affidavit of merits which set forth in substance that the consideration for the note sued upon was used to take up checks of the Detroit Milling Company in which both plaintiff and defendant were interested, and defendant, in consideration of plaintiff's promise to cancel the note in question and deliver the same to him, agreed to vote in favor of a loan by the Stott Realty Company to the David Stott Flour Mills Corporation of $150,000, so the plaintiff would not lose his interest therein, and defendant did so and plaintiff now refuses to carry out his agreement. The court rendered summary judgment against defendant, who appeals. The only question is whether the agreement set forth in the affidavit of merits is good. If so, plaintiff is not entitled to summary judgment.

The question is, assuming defendant's affidavit of merits is truthful, whether the agreement alleged to have been made by him with plaintiff, whereby in consideration of the release of defendant from liability on his promissory note he agreed as a stockholder to vote in favor of a loan from the Stott Realty Company to the David Stott Flour Mills Corporation in the sum of $150,000, both plaintiff and defendant being stockholders in both said corporations, and plaintiff being fearful unless such loan could be made he would lose his interest in the David Stott Flour Mills Corporation, was a good and sufficient consideration for the release of defendant from liability on his note. Plaintiff con-

tends such an agreement as is alleged in defendant's affidavit of merits is opposed to public policy and void. Defendant contends such an agreement is valid and binding. In order for such a contract as alleged by defendant in his affidavit of merits to be valid and binding, it must be based upon a consideration. There is a consideration if the promisee in return for a promise does anything legal which he is not bound to do or refrains from doing anything which he has a right to do, whether there is any actual loss or detriment to him or actual benefit to the promissor or not. 9 Cyc. 312, 313; 13 C.J. 316.

The contract alleged by defendant is not invalid for want of consideration.

A corporation belongs to its stockholders. They own it. Shares of stock are only proportionate interests therein. Certificates of stock are evidence of fractional ownership. Those who own a corporation not only have a right to control its affairs, but it is their duty to do so. No stockholder or group of stockholders have a right to defraud any other stockholder or group of stockholders, nor will they be permitted to take advantage of the corporation itself for their own personal benefit; but, subject to these restrictions, stockholders have a right to agree between themselves to vote together as a unit, to control and manage the affairs of a corporation, and such agreements are not contrary to public policy. 14 C.J. 913, 914, and cases cited. If such an agreement is founded upon a sufficient consideration and is not opposed to public policy, the question is whether the affidavit of merits of defendant states facts sufficient to constitute a contract. Such affidavit alleges there were parties competent to contract, a subject-matter of the contract, a valid consideration, mutuality of agreement, and mutuality of obligation. These are said to be the essentials of a valid contract. We think the showing of defendant sufficient to entitle him to a trial and the entry of summary judgment was error. Judgment reversed, with costs, and case remanded.

SHARPE, J. (for affirmance). The defense to this action, brought to recover on defendant's promissory note, is based upon the claim that the defendant, at the solicitation of plaintiff, "agreed as a stockholder to vote in favor of a loan from the Stott Realty Company to the David Stott Flour Mills in the sum of $150,000.00," in which corporations both plaintiff and defendant were stockholders, in consideration of "plaintiff's promise to cancel and deliver" to defendant the promissory note in question; that he did so vote; and that plaintiff, although requested to do so, has failed to deliver the note to him.

The stockholders of a corporation have a community of interest in the property owned by it. They can perform valid acts only when lawfully assembled in their representative capacity. When so acting, every stockholder has the right to assume that every other stockholder is exercising an independent and honest judgment on the questions presented, and that none of them has been influenced by a consideration paid to him for voting in a particular manner. As was said in West v. Camden, 135 U.S. 507, 521, 10 S.Ct. 838, 840, 34 L.Ed. 254, it was the right of the other stockholders "to have the defendant's judgment, as an officer of the company, exercised with a sole regard

to the interests of the company." A number of stockholders, before a meeting, may agree to combine together to favor any particular policy or lawful action to be considered thereat, and, if they own a majority of the stock, the minority may not, ordinarily, question their right to do so.

But the question here presented is whether one stockholder, in order to obtain a vote of the majority of the stock, may, by the payment of a cash consideration to another, secure the vote of his stock in the manner desired by him. If the defendant believed that the action sought by the plaintiff was in the interest of the corporation, he should have assented to it. He apparently did not so consider it. His vote, cast as plaintiff desired, must be treated as influenced solely by the consideration he claims he was to receive therefor. In my opinion, if the contract, as claimed by him, was entered into, it was against public policy and void.

In Thompson on Corporations (3d Ed.) vol. 2, § 995, the right of stockholders to combine in a voting trust is considered at length. The following from Smith v. San Francisco, etc., R. Co., 115 Cal. 584, 47 P. 582, 590, 35 L.R.A. 309, 56 Am.St.Rep. 119, is quoted with approval: "The stockholder cannot separate the voting power from his stock by selling his right to vote for a consideration personal to himself alone, any more than he could agree, for the same consideration, to cast the vote himself; and an agreement with others to appoint a proxy upon the same considerations would be equally invalid."

"A corporation holds its property in trust for its stockholders. The stockholders have a joint interest in the same property and in the same title. Community of interest in a common property or title imposes a community of duty and a mutual obligation to do nothing to impair either. It creates such a fiducial relation as makes it inequitable for any of those who thus share in the common property to do anything to or with it for their own profit, to the detriment of others who have the same rights." Wheeler v. Abilene Nat. Bank Bldg. Co. (C.C.A.) 159 F. 391, 393, 16 L.R.A.,N.S., 892, 14 Ann.Cas. 917.

The following decisions of this court, while not directly in point, are indicative of the rule which should be applied in this case:

"An agreement by two of the three stockholders of a corporation, who are also directors, that, in consideration of the purchase of stock, the vendee shall be employed as business manager for two years, and if at the end of that time he wishes to retire from the corporation they will repurchase his stock at a stated price, is void as against public policy, unless assented to by the other stockholder." Wilbur v. Stoepel, 82 Mich. 344 (syllabus), 46 N.W. 724, 21 Am.St.Rep. 568.

"The execution of a contract between four of the directors and stockholders of several corporations, holding a majority of the stock in each, without the consent of other stockholders, for purposes of personal gain, containing provisions for the continued employment of one of the contracting parties as manager at a fixed salary, and determining the business policy of the several corporations, is contrary to public policy, and may not be enforced specifically." Scripps v. Sweeney, 160 Mich. 148 (syllabus), 125 N.W. 72.

The judgment should be affirmed.

CONE'S EXECUTORS v. RUSSELL et al.

Court of Chancery of New Jersey, 1891. 48 N.J.Eq. 208, 21 A. 847.

In equity. On order to show cause why injunction should not issue. Heard on bill, answer, and affidavits.

PITNEY, V. C. The complainants, Lorenzo H. Cone and Rebecca C. Cone, executors, etc., of Jonathan Cone, deceased, by their bill ask that the defendants, William F. Russell and Charles H. Mason, be enjoined from voting at any stockholders' meeting of the Upper Delaware River Transportation Company by virtue of a certain power of attorney or proxy, irrevocable, executed by complainants to defendants, authorizing and empowering them to vote upon 477 shares of the stock of said corporation belonging to the complainants as executors; and praying that said power of attorney or proxy, and a certain agreement between the parties, presently to be set out, may be decreed to be null and void, and delivered up to be canceled. * * *

At the date of this instrument the complainants were the owners, as executors, of 477 shares of the stock mentioned, and the complainant Lorenzo H. Cone was the owner of 96 shares, and shortly afterwards became the owner of 10 additional shares thereof, which became subject to the contract, and added to those already owned by the defendants constituted a majority of the stock of the corporation. The power of attorney and proxy was duly executed by the complainants as executors, and also one by L. H. Cone individually; and at the annual meeting of April, 1889, the defendants, by their use, elected themselves and some of their employes directors, and thereby secured a majority of the board. The new board elected the defendant Russell president, with a salary of $1,500 a year; the defendant Mason treasurer, with a like salary; and one Beek, a clerk of the defendants, secretary of the company, with a salary of $500 a year; and appointed L. H. Cone manager thereof, with a salary of $2,500 a year. At the same annual meeting a majority of voices of the stockholders voted in favor of a motion to limit the total expenditure for salaries of officers to $1,000 per year, but the vote by shares given by the defendants refused to sustain the motion. From that date to this the affairs of the corporation have been managed by the defendants, with the actual ownership of 80 out of 1,300 shares of its stock. As might have been expected, differences soon arose between the parties, resulting in three bills in this court prior to the one underlying the present motion. Complainants base their rights to the relief now sought upon three grounds: *First.* They say they were induced to enter into the agreement and execute the proxies by a fraud practiced upon them by the defendants, the particulars of which are set out in the bill. *Ex parte* affidavits on both sides, bearing on the question of fraud or no fraud, have been read. I deem it worth while to say, on this point, only that I think the fraud is not made out with sufficient certainty and clearness, and with sufficient weight of evidence, to warrant interposition by interlocutory injunction. The *second* ground taken by the complainants is that the contract in question is against public policy, and tends to work a fraud on the other stockholders, and is void upon

that ground. And the *third* ground is that the complainants, executors and trustees, had no right to depute their trust to others, as is done by this agreement, and that on that account also it should be decreed void.

The theory upon which the capital of numerous persons is associated in various proportions, in the shape of a trading corporation, to be managed by a committee of the stockholders, is that such committee shall truly represent and be subject to the will of the majority in interest of the stockholders. The security of the small stockholders is found in the natural disposition of each stockholder to promote the best interests of all, in order to promote his individual interests. A member of an ordinary partnership has an additional security in the personal character of each of his partners, and may decline to be associated with any whom he does not know and approve. But a stockholder in a corporation cannot control the *personnel* of his associates, and must rely upon their self-interest alone. * * * Our legislature has, since the decision in Taylor v. Griswold, authorized the use of proxies, limiting them, however, to three years. But the principle still remains that the proxy is supposed to vote for the principal, and in his interest. If a majority of the stock is owned by one person, he has no right to use his power as such owner to advance his private interests at the expense of the minority. And in like manner he has no right to depute to another, who has little or no interest in the corporation, a power to use his stock for that purpose. Such deputation is the more dangerous because the person intrusted with the power has no such inducement to promote the interests of the corporation as the stock-owner has. Where the majority of the stock is owned by one man, or set of men acting in concert, the minority are, to some extent, protected by the natural interest of the majority to promote the real interest of the corporation; but where a person who has little or no actual ownership has the unrestricted voting power of a majority of the stock, the minority loses this protection, and what may be properly termed the underlying and fundamental understanding and contract upon which the association is founded is abandoned and broken. The motive which may induce the owner of a controlling interest in the corporation to deprive himself of and depute to another the power to use it as he may see fit, during a fixed period, may be of little consequence to his associates, but is usually found in some consideration of personal gain. In the case in hand it is the employment of complainant L. H. Cone as manager for a fixed term, and at a fixed salary, and irrespective of the actual value of his services. The avowed object and purpose of the defendants was to secure to themselves like employment and salaries. The mere statement of the affair seems to me to condemn it. The motive was in itself improper and unlawful. Servants of a corporation should be employed and paid upon their merits; and buying votes for an office in a corporation is of the same objectionable character as buying them for a public office. The same may be said of buying the right to control the business policy and management of the affairs of a corporation. * * * In Foll's Appeal, 91 Pa.St. 434, the supreme court of Pennsylvania went so far as to refuse specific performance of a contract to sell a comparatively few

shares of stock in a national bank, where the avowed object was to enable the purchaser to obtain the control of the bank, and who, for that purpose, had already bought up, largely with borrowed money, almost a majority of the stock. The learned judge, speaking for the court, says, (page 437:) "The stock, as now held, is scattered among a variety of people, and held in greater or lesser amounts. It is difficult to see how the small stockholders who have modest earnings invested in it, the depositors who use it for the safe-keeping of their money, or the business public who look to it for accommodation in the way of loans, are to be benefited by the concentration of a majority of its stock in the hands of one man, or in such a way that one man and his friends shall control it. Especially is this so when, as here, an attempt is made to control it by the use of borrowed capital. The temptation to use it for personal ends, in such case, is very strong." For an instance of the abuse of power by an actual majority in ownership of stock in a corporation, see Meeker v. Iron Co., 17 F. 48.

Following the reasoning of these cases, I conclude that the contract complained of in this suit is void as against public policy. This conclusion does not reach so far as to necessarily forbid all pooling or combining of stock, where the object is to carry out a particular policy with the view to promote the best interests of all the stockholders. The propriety of the object validates the means, and must affirmatively appear. * * * For these reasons I am of the opinion that the contract and proxy set out and mentioned in the bill are void, and complainants are entitled to relief against them, and that the injunction prayed for must go. I will advise an order accordingly.

(b) Pooling and Voting Trusts

NEW YORK STOCK CORPORATION LAW

§ 50. *Voting trust agreements.* A stockholder, by agreement in writing, may transfer his stock to a voting trustee or trustees for the purpose of conferring the right to vote thereon for a period not exceeding ten years upon the terms and conditions therein stated. Every other stockholder may transfer his stock to the same trustee or trustees and thereupon shall be a party to such agreement. The certificates of stock so transferred shall be surrendered and cancelled and new certificates therefor issued to such trustee or trustees in which it shall appear that they are issued pursuant to such agreement, and in the entry of such ownership in the proper books of such corporation that fact shall also be noted, and thereupon such trustee or trustees may vote upon the stock so transferred during the term of such agreement. A duplicate of every such agreement shall be filed in the office of the corporation and at all times during business hours be open to inspection by any stockholder or his attorney. The provisions of this section shall not authorize the transfer of stock of a banking corporation to a voting trustee or trustees. The trustee or trustees shall keep at their office or at a place available to certificate holders correct books of account of all their business and transactions, and a book to be known as the certificate book containing the names, alphabetically ar-

ranged, of all persons who are voting trust certificate holders, showing their places of residence, the number of shares of stock represented by the certificates held by them respectively, and the time when they respectively became the owners thereof. The certificate book shall be open daily, during at least three business hours, for inspection by any person who shall have been a certificate holder for at least six months immediately preceding his demand, or by any person holding or thereunto in writing authorized by the holders of at least five per centum of all of the outstanding certificates; provided (a) that such inspection shall not be for the purpose of communicating with certificate holders in the interest of a business or object other than the business of the corporation, and (b) that such certificate holder or other person has not within five years sold or offered for sale any list of stockholders or voting trust certificate holders of such corporation or any other corporation or aided or abetted any person in procuring such list for any such purpose; and provided further that such inspection may be denied to such certificate holder or other person upon refusal to furnish to such voting trustee or trustees a written statement that such inspection is not desired for purpose (a) and that such certificate holder or other person has not been connected with any list as provided in (b). Persons so entitled to inspect the certificate book may make extracts therefrom. Any trustee who shall neglect or refuse to keep or cause to be kept such books or to keep any certificate book open for inspection, as herein required, shall forfeit to the people the sum of fifty dollars for every day he shall so neglect or refuse. If any trustee shall wilfully neglect or refuse to make any proper entry in such book or books or shall neglect or refuse to exhibit any such certificate book or to allow any such certificate book to be inspected and extracts taken therefrom as provided in this section, each such trustee shall forfeit and pay to the party injured a penalty of fifty dollars for every such neglect or refusal, and all damages resulting to him therefrom.

DELAWARE GENERAL CORPORATION LAW

Sec. 18. *Fiduciary Stockholders; Voting Power of; Voting Trusts:*—Persons holding stock in a fiduciary capacity shall be entitled to vote the shares so held, and persons whose stock is pledged shall be entitled to vote, unless in the transfer by the pledgor on the books of the corporation he shall have expressly empowered the pledgee to vote thereon, in which case only the pledgee, or his proxy may represent said stock and vote thereon.

One or more stockholders may by agreement in writing deposit capital stock of an original issue with or transfer capital stock to any person or persons, or corporation or corporations authorized to act as trustee, for the purpose of vesting in said person or persons, corporation or corporations, who may be designated Voting Trustee or Voting Trustees, the right to vote thereon for any period of time determined by such agreement, not exceeding ten years, upon the terms and conditions stated in such agreement. Such agreement may contain any other lawful provisions not inconsistent with said purpose. After the filing of a copy of such agreement in the principal office of the corporation

in the State of Delaware, which copy shall be open to the inspection of any stockholder of the corporation or any beneficiary of the trust under said agreement daily during business hours, certificates of stock shall be issued to the Voting Trustees to represent any stock of an original issue so deposited with them, and any certificates of stock so transferred to the Voting Trustees shall be surrendered and cancelled and new certificates therefor shall be issued to the Voting Trustees, and in the certificates so issued it shall appear that they are issued pursuant to such agreement, and in the entry of such Voting Trustees as owners of such stock in the proper books of the issuing corporation that fact shall also be noted. Said Voting Trustees may vote upon the stock so issued or transferred during the period in such agreement specified; stock standing in the names of such Voting Trustees may be voted either in person or by proxy, and in voting said stock, such Voting Trustees shall incur no responsibility as stockholder, trustee or otherwise, except for their own individual malfeasance. In any case where two or more persons are designated as Voting Trustees, and the right and method of voting any stock standing in their names at any meeting of the corporation are not fixed by the agreement appointing said Trustees, the right to vote said stock and the manner of voting the same at such meeting shall be determined by a majority of said Trustees, or if they be equally divided as to the right and manner of voting the same in any particular case, the vote of said stock in such case shall be divided equally among the Trustees.

At any time within one year prior to the time of expiration of any such voting trust agreement as originally fixed or as extended as herein provided, one or more beneficiaries of the trust under such voting trust agreement may, by agreement in writing and with the written consent of such Voting Trustees, extend the duration of such voting trust agreement for an additional period not exceeding ten years. Said Voting Trustees shall, prior to the time of expiration of any such voting trust agreement, as originally fixed or as previously extended, as the case may be, file in the principal office of the corporation in the State of Delaware a copy of such extension agreement and of their consent thereto, and thereupon the duration of such voting trust agreement shall be extended for the period fixed in such extension agreement; provided, however, that no such extension agreement shall affect the right or obligations of persons not parties thereto.

WARREN et al. v. PIM et al.

Court of Errors and Appeals of New Jersey, 1904. 66 N.J.Eq. 353, 59 A. 773.

Appeal from Court of Chancery.

Bill by Lyman E. Warren and others against J. Harold Pim and others. Decree for plaintiffs, and defendants appeal. Affirmed.

DIXON, J. The bill of complaint in this cause was filed in January, 1903, by Lyman E. Warren against the Fisheries Company, a corporation of this state, J. Harold Pim, Langley Archer West, and Montgomery Horne-Payne, constituting what is called the "Pim Committee," and the Association of Foreign Shareholders of the Fisheries Company of

New Jersey, Limited, a corporation of Great Britain. Subsequently Nathaniel B. Church, Adolph Hirsh, James E. Heller, the American Net & Twine Company, William B. M. Chace, and John Shepard were admitted as complainants in the suit. The objects of the bill are, first, to compel a transfer to the complainants, upon the books of the Fisheries Company, of certain shares of stock in that company now standing on its books in the names of the Pim Committee, but claimed by the complainants as their property; second, to restrain the Fisheries Company from holding any election of directors until such transfer shall have been made; and, third, to have it decreed that a certain "voting trust," under which the Pim Committee and the British Association claim some control over shares of stock in the Fisheries Company, is against public policy, fraudulent, inoperative, null, and void. The bill was accompanied by affidavits and exhibits. The members of the Pim Committee and the British Association filed an answer, which was also accompanied by affidavits and exhibits. The Fisheries Company filed a separate answer, adopting substantially the views of the complainants. The bill and the answer of the Pim Committee and the British Association disclose the grounds of litigation. The cause being submitted on bill and answers, the Chancellor on November 10, 1903, made final decree in conformity with the prayer of the bill, and from that decree the appeal now to be decided was taken.

It appears that when the Fisheries Company was organized, on May 25, 1900, a majority of the shares of its stock was taken by persons residing in Great Britain and Ireland, and, in order that a combination called a "voting trust" might be formed, enabling some representative of these shareholders to control the Fisheries Company, the British Association was incorporated. As a preliminary to the formation of the voting trust, most of the shares of these foreign holders (being a majority of the stock of the Fisheries Company) were transferred to the Pim Committee. Afterwards, on November 12, 1900, a deed poll was executed by that committee and the British Association, which recites the authority of the Pim Committee to create a voting trust of the shares of the Fisheries Company, and that the British Association is the proposed voting trust, and then, to complete the constitution of the trust, declares as follows: "The said shares in the Fisheries Company now held by the said J. H. Pim, L. A. West and R. M. Horne-Payne * * * shall be held by the Association with all rights and powers against third persons as if it were the absolute owner and holder thereof, but as between the Association and the owners of the deposited shares the certificates of the Association issued to such owners shall carry all rights and benefits except that of voting, subject nevertheless to the provisions hereof. * * * The Association will recognize the registered owner of any deposited share as the absolute equitable owner thereof, subject to these presents. * * * The deposited shares shall be held by the Association upon trust that they may and shall according to the best of their discretion do the things following, that is to say: Exercise all voting rights incident to the ownership of shares as and when the Association shall think it expedient to exercise the same; receive all dividends and bonuses and other moneys receivable in respect of the deposited shares; raise or borrow on the security of the

deposited shares any money required for the purposes of the execution of the trust; take all such actions and proceedings as they think expedient from time to time to protect the interests of the owners of the deposited shares. * * * Dividends received * * * shall be paid over to the respective owners of the deposited shares, but the Association may retain * * * any sum which the Association may deem it advisable to set aside to meet contingencies and anything due * * * for expenses. * * * The Trust shall be closed * * * when and so soon as the Association shall by deed declare that it is to be closed, or when the owners of three-fourths of the deposited shares of each class by notice in writing to the Association declare the trust to be closed, or when the last survivor of the now existing descendants of Her Majesty shall have been dead for 20 years, or when fifty years from the execution hereof shall have elapsed." These excerpts denote the character of the voting trust now in question, and, it may be added, the corporate powers of the association are such as would enable it to execute the trust, but the owners of the deposited stock, as such, have no voice in its management. * * *

Keeping in mind the legal principles and statutes above mentioned, I come to the question to be decided in the present case: Is it lawful for a corporation organized under the laws of a foreign country to vote upon the stock of a New Jersey corporation which it does not own? An affirmative answer is, I think, rationally impossible. On the doctrine established for this state by the case of Taylor v. Griswold, ubi supra, such an answer must be based on the clear intent of some statute, and no such statute can be found. But it is said the policy indicated by our statutes is such that on the principle of comity the courts must answer the question affirmatively, in order to concede to foreign corporations such privileges in domestic corporations as the Legislature has designed that our corporations should enjoy in foreign corporations. In my view, the utmost demands of comity are inadequate for the end sought. The Legislature has given its sanction to the exercise by New Jersey corporations of the right to own and (while owners) to vote upon the stock of corporations created by the laws of sister states. The corporation of a sister state, whose laws permitted the right thus sanctioned to be exercised, might invoke the doctrine of comity to support them in exercising a similar right in our corporations, but the claim could fairly go no further. That falls far short of the present exigency. The corporation to be favored comes not from a sister state, but from a foreign country. It is not shown that the laws of that country would extend a like favor to our corporations, and, even if they would, our corporations are not empowered to enjoy it; and the stock to be voted on is not owned by the corporation desiring to vote upon it, while ownership is made a condition essential to the exercise of the voting power by our own corporations either within or without the state. The question as to who shall exercise the voting power in our corporations is not one of mere private concern. It involves matters of public interest. Whether the laws of the state shall be faithfully observed in the management of these bodies depends primarily on the parties voting upon the stock. Even if, on principles of comity, such voting power should be conceded by the courts to corporations of sister states, which are subject to the

federal Constitution and laws, and to state Constitutions of which we take judicial cognizance, it would by no means follow that a like concession ought to be made to corporations organized under laws wholly unknown to us, and over which our courts, either federal or state, cannot acquire personal jurisdiction without their consent. A public policy having so wide a sweep ought, I think, to be supported by a clear expression of legislative purpose.

I therefore conclude that the British Association cannot lawfully exercise the voting power which it was the design of the deed poll to confer upon it. Consequently, as the object of the proposed trust wholly fails, the complainants are entitled to have the stock which they own restored to them, whether the trust was concurred in or not, and also to enjoin the association from voting on stock belonging to the stockholders in the Fisheries Company. * * *

PITNEY, J. I shall vote for an unqualified affirmance of the decree made by the Court of Chancery herein. The grave importance of the legal and equitable questions involved, and the fact that a majority of this court is not agreed upon the grounds of decision, justify an extended discussion of the case.

I agree with MR. JUSTICE DIXON that the plain object of the deed poll, and its necessary effect if it be valid, are to separate the voting power from the ownership of the stock covered thereby, and to lodge that power in the "trustees" named in the deed poll. By the terms of the deed, this arrangement continues for a term of 50 years, unless the "trustees" shall sooner declare the trust to be closed, or unless the owners of three-fourths of the deposited shares of each class declare it to be closed. I do not think, however, that this situation necessarily or even properly presents the question whether a foreign corporation, as distinguished from a domestic one, can lawfully exercise such a power upon stock of a New Jersey corporation not owned by it. In my opinion, such a power—a practically irrevocable voting power, uncoupled with any ownership or interest in the stock itself—is obnoxious to the plain terms and spirit of our general corporation act; and this equally whether the donee of the power be citizen or alien, domestic corporation or foreign. * * *

The general trend of decisions throughout the country condemns the irrevocable voting trust. Some of these decisions are cited in Cone v. Russell and White v. Thomas Inflatable Tire Co. See, also, Shepaug Voting Trust Cases, 60 Conn. 576, 24 Atl. 34; Harvey v. Linville Imp. Co., 118 N.C. 693, 24 S.E. 489, 32 L.R.A. 265, 54 Am.St.Rep. 749; and an article in 38 Am.Law.Reg. (New Series) 1899, p. 50. Brightman v. Bates, 175 Mass. 105, 55 N.E. 809, is cited as an authority to the contrary. It is true that Chief Justice Holmes in that case entered into some discussion of the validity of pooling agreements among stockholders, with the result that he found no reason to disapprove of them in toto and under all circumstances. Such a total disapproval would have been necessary to overthrow the covenant there sued on. But he based the decision largely upon the fact that the plaintiff had a general finding in his favor in the trial court. In that part of the opinion which deals with the validity of pooling agreements and voting trusts, the

learned Chief Justice, as I take it, employed inaccurate reasoning, when he declared: "A stockholder has a right to put his shares in trust whatever his motive. If the trust is an active one he cannot terminate it at will," etc. But in truth and in essence, and for all purposes of a court of equity, a voting trust that has for its sole object the permanent separation of the voting power from the substantial ownership of the shares is not a putting of the shares in trust. It is a putting of false evidence of share ownership into the hands of the trustee, for the purpose of enabling the trustee to represent himself as a shareholder at the stockholders' meetings, and thereupon be admitted to the election. * * *

Any arrangement that permanently separates the voting power from stock ownership nullifies, to the extent of the stock involved, the annual submission of the question of the management of the company to the stockholders. Where, as here, the arrangement includes a majority of the stock, and extends for a period of 50 years, it renders all annual elections in the meantime a hollow form. If I am correct in the view that such an arrangement is wholly prohibited by the act, the deed poll is void as contravening public policy in this respect. If the prohibition of the act is not absolute, but intended solely for the benefit of the corporators, and subject to be waived by their unanimous consent, yet the deed poll violates the substantial rights of the nonassenting stockholders, and is for that reason contrary to public policy. For, of course, the plan of corporate management prescribed by the act, and the method of corporate control therein provided for, form an essential part of the constitution of the corporation, to the enforcement of which every stockholder is equally entitled. Public policy is as much concerned in overthrowing contracts that involve or contemplate the commission of a civil injury, the deprivation of civil rights, or the perpetration of a fraud upon third parties, as in nullifying contracts that violate a statutory prohibition. * * *

It follows, of course, that the nonassenting stockholders, being the very class against whose civil rights the scheme attempted to be established by the deed poll most directly and injuriously operates, are entitled to an injunction against its operation. All the complainants are in this class, and in this aspect are entitled to exclude the association from voting upon the trusteed stock, because the persons who constitute the association have no interest, as trustees or otherwise, in the deposited stock, and hold it solely under an arrangement for the irrevocable divorcement of the voting power from the ownership. As I read the decree under review, it confines the injunction to so much of the deposited stock as is now owned by certain of the complainants herein. If the British depositors had been before the court, the injunction might have been extended to all the deposited stock. The interest of the nonassenting stockholders, even considering them merely as lawful voters asking that unlawful voting by others be prohibited, is sufficiently obvious, and entirely settled by authority. In re St. Lawrence Steamboat Co., 44 N.J.L. 529; In re Leslie, 58 N.J.L. 609, 33 A. 954; State v. Wrightson, 56 N.J.L. 126, 28 A. 56, 22 L.R.A. 548; Smith v. Wanser, 68 N.J.L. 249, 253, 52 A. 309.

Those of the complainants who hold by purchase shares of stock that were placed in the so-called trust are not debarred by the action

of their assignors in so doing. They do not claim any right or remedy by virtue of the illegal agreement, but in repudiation of it. In such a case, depending on grounds of public policy, these complainants are not debarred by the maxim, "in pari delicto." So it was held in Cone v. Russell, 48 N.J.Eq., at page 217, 21 A. 847, and ought to be held in every similar case. * * *

I concede, of course, that each stockholder may at each election vote as he chooses, provided he vote honestly. But from this it by no means follows that he may make an agreement that shall bind his vote for a term of years, as intimated by Chief Justice Holmes in Brightman v. Bates, 175 Mass., at page 110, 55 N.E. 809. The pith and essence of the annual election of directors established by the corporation act is the periodical appeal to the self-interest of the proprietors, with the current experience of the company—its success or nonsuccess—to guide them. It is based upon the notion that experience is a safer reliance than prevision, or, in homely phrase, that "hindsight is better than foresight."

It is said that stockholders, in exercising their voting rights, do not stand in a fiduciary relation to each other. But this does not properly apply at all to ultra vires acts amounting to a breach of the agreement of incorporation, nor does it give any countenance to the notion that those who are not stockholders may vote. Nor can I concede that a stockholder, in voting, has a right to disregard entirely the interests of his fellow stockholders. The ethical notion that underlies the maxim, "Sic utere tuo ut alienum non lædas," forbids.

There is a close analogy between corporate elections and the governmental elections after which they are modeled. The practical difference lies chiefly in the number of persons affected. In Montclair Military Academy v. North Jersey Street Railway Co., 65 N.J.L. 328, 47 A. 890, the Supreme Court took the view that votes conferred upon abutting property owners, entitling them, by the voice of a majority in interest, to consent to the laying of a street railway, being conferred for the protection of their property, might be sold for considerations of advantage personal to the voter. But this court unanimously rejected that view. S. c., 70 N.J.L. 229, 232, 57 A. 1050, 1051. Justice Dixon, who delivered the opinion here, used the following language: "For the decision of the matter thus contemplated, the Legislature treated these owners as a class, every member of which had similar interests to subserve—interests that in some degree were common to all. Properly to meet the confidence thus reposed, it was incumbent to each member to bear in mind and be influenced by those common interests only, so that his judgment would be as fair toward his neighbor as it was toward himself. To permit any one of the class to barter for private and exclusive gain this power over the concerns of his fellows would be subversive of the benign purpose of the Legislature in delegating it."

All the arguments adduced in support of the deed poll are not only based upon a view of the corporation act quite different from that which I have endeavored to express, but they also proceed upon the theory that the deed poll does in truth establish some sort of trust for the benefit at least of the British stockholders who were subscribers

thereto. I confess that a somewhat careful examination of the instrument fails to disclose to me what the trust may be, beyond the mere untrammeled exercise by the individual "trustees" and their successors, and their irresponsible delegates and subdelegates, of a limitless discretion about using or not using the voting power normally incident to a majority of the shares of the Fisheries Company. If there were no other valid objection to the instrument, it seems to me that, as a trust deed, it is void for indefiniteness and uncertainty.

For all these reasons, I shall vote for the affirmance of the decree, without qualification. * * *

SMITH et al. v. SAN FRANCISCO & NORTH PACIFIC RAILWAY COMPANY et al.

Supreme Court of California, 1897. 115 Cal. 584, 47 P. 582.

Action by Smith and others against the San Francisco & North Pacific Railway Company and others. Judgment for plantiffs. Defendants appeal. Reversed.

HARRISON, J. At the election for directors of the San Francisco & North Pacific Railway Company, which was had at the annual meeting of the stockholders held February 25, 1896, the votes offered by Peter Gundecker, G. E. Wagner, and Sidney V. Smith, in whose names certain shares of stock stood on the books of the corporation, were rejected, and at the close of the election the chairman of the meeting announced that Antoine Borel, A. W. Foster, Andrew Markham, P. N. Lilienthal, George A. Newhall, James B. Stetson, and John L. Howard had been duly elected directors of said corporation for the year then next ensuing. The votes of Gundecker and Wagner were rejected upon the ground that they were not bona fide stockholders in the corporation, and the vote of Smith was rejected upon the ground that by virtue of a certain agreement between him and two other stockholders —Foster and Markham—the stock of the three had been pooled for the term of five years, to be voted as a unit, and was cast in pursuance of that agreement. If the votes thus rejected had been received, the election would have resulted in the choice of Smith as one of the directors instead of Lilienthal. The present action was brought under section 315 of the Civil Code, for the purpose of having it declared that Smith instead of Lilienthal was elected a director at said election. The superior court found that Gundecker and Wagner were bona fide stockholders, and that their vote should have been received, and that the agreement by Smith with the other stockholders did not preclude him from the right to vote the stock standing in his own name as he might choose, and that the vote by the other stockholders for his stock was unauthorized and his own vote should have been received. Judgment was thereupon rendered that Lilienthal had not been chosen as a director, and was not entitled to exercise the office, and that at the said election Smith was chosen one of the directors and was entitled to be so recognized. A motion for a new trial on behalf of the defendants was denied, and from both the judgment and the order denying the new trial appeals have been taken. * * *

2. The Smith Stock. The exclusion of the vote tendered by Smith upon the stock standing in his name was by reason of the following facts: In February, 1893, the estate of James M. Donahue, deceased, was the owner of 42,000 shares, or thereabouts, of the capital stock of the defendant railway company, which the superior court of Marin county had ordered to be sold in the course of the administration of his estate. Prior to the sale, an agreement was entered into between Smith, Foster, and Markham for the purchase of this stock as an entirety, upon the representations of Smith that upon acquiring the shares an agreement would be made by them whereby, in order to secure the control of the management and business policy of the railway company, and for its prudent and economical management in the interest of all of its stockholders, the said 42,000 shares should for the term of five years thereafter be voted as a unit in the election of directors of said railway company. In pursuance of this agreement, Smith and Foster, on the 24th of February, made their joint bid for the shares, offering to purchase them as an entirety for the sum of $800,000 and upwards, and by order of court their bid was accepted, and on March 23d the sale was completed, and the price paid. After the making of the bid, and before the consummation of the purchase and completion of the sale, Smith prepared the agreement for the voting of the shares as a unit that had been contemplated by the parties to the purchase; and on the 22d of March the same was executed in triplicate between Smith, Markham, and Foster. By this instrument, after reciting therein that the parties thereto had purchased the 42,000 shares of stock, and had agreed to retain the power of voting the stock for five years, "so as to keep the control of the corporation from passing to persons other than themselves," it was "mutually agreed between said Foster, Markham, and Smith that they will, during said period, retain the power to vote said shares in one body; and that the vote which shall be cast by said shares, whether for directors or for any other purpose, shall be determined by ballot between them or their survivors." It was in the contemplation of the parties to the agreement that they might sell or otherwise dispose of some of the shares, and accordingly they made provision in this instrument for retaining the right to vote the stock so sold by them, and annexed thereto the form of an agreement to be taken by them from their vendees. This form or draft recited the purchase of the 42,000 shares by Foster, Smith, and Markham, and that "for the purpose of keeping control of said road in the interest of themselves and of all persons who shall buy any portion of the stock from them," they have agreed that for the period of five years "they shall vote the said stock in one block" at all elections for officers. The purchase of the stock by Foster, Smith, and Markham was completed, and the price therefor paid on the 23d of March, and 12,336 shares of the stock were transferred on the books to each of them; 5,000 shares being left in the name of the Mercantile Trust Company, subject to some prior trust. Prior to the day for the election in 1896, a conference was called to be held between Foster, Smith, and Markham, upon proper notice therefor, to determine by ballot how the vote of the shares should be cast at the next annual meeting for directors, and in accordance with said notice

said conference was held, at which Foster and Markham were present, and upon a ballot had thereat it was determined that said shares should be voted for Foster, Markham, Newhall, and Lilienthal as directors. The foregoing matters are alleged in the answers of the defendants, and at the trial the defendants sought to introduce in evidence the agreement of March 22d, and offered to prove in connection therewith the matters set forth in their answer relative thereto; but upon the objection by the plaintiffs to this offer, "on the ground that said agreement was not a proxy, and did not provide that any of the parties thereto should vote the stock belonging to the other, and that it was revoked before the election, and was invalid as against public policy," the evidence was excluded; the court saying: "I will assume, for the purpose of my ruling, that it was a valid agreement, but that it was not an agreement which gave any authority to any other person to cast the vote of Mr. Smith." * * * No particular form of words is requisite to constitute a proxy. Mor.Priv.Corp. § 486. Like any other agency, the instrument by which it is created may be informal; but if, in order to give effect to its language in view of the purpose for which it is executed, it is necessary to construe the instrument as creating an agency, such construction will be given. The instrument executed between the parties must, therefore, be held to be a proxy, and to authorize the vote of the 42,000 shares of stock to be cast in accordance with the determination of the majority of the parties thereto; and, if it was made upon a consideration sufficient to bind the parties to its enforcement, it must be regarded as still operative. One of the inducements for the purchase of the stock, and under which the parties entered into the agreement, was that the shares should be voted in one body, and held for five years as a unit. It is immaterial that the voting agreement was not reduced to writing and executed until after the bid had been made for the stock. It was so executed before the parties thereto had completed the purchase, and become the owners of the stock by paying the purchase price. * * * There was thus a sufficient consideration for the agreement granting the right to vote the stock. It was in the nature of a power coupled with an interest, and, being given for a valuable consideration, could not be revoked at the pleasure of either. Hey v. Dolphin, 92 Hun, 230, 36 N.Y.S. 627.

Although the court, in excluding this evidence, assumed that the instrument was valid, counsel for respondents have presented an argument in support of their further objection thereto that the instrument is invalid by reason of being against public policy; and it therefore becomes necessary to consider this objection, inasmuch as the action of the court, rather than its reason for so acting, is to be reviewed; for, if the instrument is invalid, the refusal of the court to allow any effect to be gained from its exercise was proper. "Public policy" is a term of vague and uncertain meaning, which it pertains to the law-making power to define, and courts are apt to encroach upon the domain of that branch of the government if they characterize a transaction as invalid because it is contrary to public policy, unless the transaction contravenes some positive statute or some well-established rule of law. Sir George Jessel, as master of the rolls, said in Besant

v. Wood, 12 Ch.Div. 605, that public policy is "to a great extent a matter of individual opinion, because what one man or one judge might think against public policy another might think altogether excellent public policy." And in another case (Registering Co. v. Sampson, L. R. 19 Eq. 465) the same jurist said: "If there is one thing which, more than another, public policy requires, it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts, when entered into freely and voluntarily, shall be held sacred, and shall be enforced by courts of justice." It is not in violation of any rule or principle of law for stockholders who own a majority of the stock in a corporation to cause its affairs to be managed in such way as they may think best calculated to further the ends of the corporation, and for this purpose to appoint one or more proxies, who shall vote in such a way as will carry out their plan. Nor is it against public policy for two or more stockholders to agree upon a course of corporate action, or upon the officers whom they will elect; and they may do this either by themselves or through their proxies, or they may unite in the appointment of a single proxy to effect their purpose. Any plan of procedure they may agree upon implies a previous comparison of views, and there is nothing illegal in an agreement to be bound by the will of the majority as to the means by which the result shall be reached. If they are in accord as to the ultimate purpose, it is but reasonable that the will of the majority should prevail as to the mode by which it may be accomplished. It would not be an illegal agreement if articles of partnership should provide that stock in a corporation owned by the partnership, though standing in the individual names of the partners, should be voted by one of its members; and it is no more against public policy for such an agreement to be entered into between stockholders whose interests in the stock are separate than where their interests are joint. Viewed from considerations of public policy merely, it is immaterial whether such an agreement is made by the members of an existing partnership, which owns the shares, or in pursuance of an agreement by two or more persons to form a partnership for their purchase, or to purchase them for their joint account, or as one of the terms of an agreement for their purchase by persons who contemplate no relation to each other, other than that of owning stock in the same corporation. Such agreement would in any case be outside of the corporation, and disconnected with the interest of every other stockholder, and in either case the same rules would control. Whether such an agreement is illegal, so that any action or vote under it can be set aside, or is of such a character that it will not be enforced, will depend upon the object with which it is made, or the acts that are done under it, and will be governed by other rules of law. * * *

Neither is it illegal or against public policy to separate the voting power of the stock from its ownership. The statute authorizes the stockholder to vote by proxy, and it was held in People's Home Sav. Bank v. Superior Court of City and County of San Francisco, 104 Cal. 649, 38 P. 452, that a by-law restricting the selection of proxies to stockholders was invalid, that the statute placed no limitation upon the right of selection, and that a stockholder may appoint as his proxy

one who is an entire stranger to the corporation. The right to appear by proxy implies, of itself, that the voting power may be separated from the ownership of the stock; and, unless the authority of the proxy is limited by the terms of his appointment, he is necessarily required to use his own discretion in any vote that he gives. Being the agent of the stockholder, he is required to exercise this discretion in behalf of his principal; but he is at liberty to use his own discretion as to the means by which his principal's interest will be best subserved. The cases in which it has been said that the stockholder could not divest himself of the voting power of his stock, and that it should not be separated from the ownership of the stock, were cases which involved either the sufficiency of the agreement by which the voting power was transferred, or the validity of the purpose for which the power was to be exercised. The proxy must exercise a discretion of the same nature as that which the stockholder is authorized to exercise, and an authority to do otherwise would be invalid; but the authority to exercise a discretion differs from an authority to perform a particular act. Under an appointment without words of limitation, the proxy may act against the interests of the stockholder, or even against the interests of the corporation, and the corporation, as well as the stockholder, will be bound by his act as fully as if the stockholder had acted in person; while, if the authority had been directed in terms to that act, it might have been invalid. The distinction is that between an unlawful exercise of a lawful power and the attempt to authorize the exercise of an unlawful power.

The question has been presented in cases of voting trusts, but an examination of these cases will show that the question has arisen either when the authority was expressly given to carry out some illegal purpose, or when, having been given without any consideration, though purporting to be for a definite term, subsequent owners of the stock have sought to revoke it before the expiration of the term. Shepaug Voting-Trust Cases, 60 Conn. 553, 24 A. 32, sometimes reported under the name of Bostwick v. Chapman; White v. Tire Co., 52 N.J.Eq. 178, 28 A. 75. We have been cited to no instance where the purpose of a proxy given upon a sufficient consideration was lawful, and the person by whom the proxy was created continued to be the owner of the stock, in which the agreement has been held invalid. The stockholder cannot separate the voting power from his stock by selling his right to vote for a consideration personal to himself alone, any more than he could agree, for the same consideration, to cast the vote himself; and an agreement with others to appoint a proxy upon the same considerations would be equally invalid. In Cone v. Russell, 48 N.J.Eq. 208, 21 A. 847, an agreement by the purchaser of stock to give to other stockholders his irrevocable proxy, for the purpose of securing and maintaining the control of the company, was held invalid, for the reason that it was one of the terms of the agreement that the directors to be elected under its provisions should employ the one giving the proxy at a fixed salary during its existence. Such an agreement was held to operate as an inducement to elect directors who would not act disinterestedly for the benefit of all of the stockholders, but rather to promote the interest of the parties to the agreement alone,

and was therefore void, as being against public policy. The court, however, said: "This conclusion does not reach so far as to necessarily forbid all pooling or combining of stock, where the object is to carry out a particular policy with the view to promote the best interests of all the stockholders." * * *

From the foregoing considerations it follows that the superior court erred in finding that Gundecker and Wagner were bona fide stockholders in the defendant railway company, and also in refusing to receive in evidence the instrument of March 22d, and the evidence offered by the defendants in connection therewith, for the purpose of sustaining the averments of their answer. The judgment and order denying a new trial are reversed.

RINGLING BROS.-BARNUM & BAILEY COMBINED SHOWS INC., et al. v. RINGLING.

Supreme Court of Delaware, 1947. 53 A.2d 441.

Appeal from an order of the Court of Chancery for New Castle County. The appellee instituted a proceeding under Section 31 of the Delaware Corporation Law (Rev. Code of Del., 1935, § 2063) to determine the validity of an election of directors at the 1946 annual stockholders meeting of the corporate appellant (a Delaware corporation) and to determine the right of the individual appellants to hold office as directors or officers of the corporation. The Vice Chancellor decided that no valid meeting of stockholders had been held and that a meeting should be held before a master to be appointed by the Court of Chancery pursuant to Section 31. Ringling v. Ringling Bros.-Barnum & Bailey Comb. Shows, 49 A.2d 603. (Del.Ch.) From the order entered in conformity with the Vice Chancellor's opinion, the appellants brought this appeal. The parties will be referred to by their designations in the court below.

PEARSON, J., delivering the opinion of the court:

The Court of Chancery was called upon to review an attempted election of directors at the 1946 annual stockholders meeting of the corporate defendant. The pivotal questions concern an agreement between two of the three present stockholders, and particularly the effect of this agreement with relation to the exercise of voting rights by these two stockholders. At the time of the meeting, the corporation had outstanding 1000 shares of capital stock held as follows: 315 by petitioner Edith Conway Ringling; 315 by defendant Aubrey B. Ringling Haley (individually or as executrix and legatee of a deceased husband); and 370 by defendant John Ringling North. The purpose of the meeting was to elect the entire board of seven directors. The shares could be voted cumulatively. Mrs. Ringling asserts that by virtue of the operation of an agreement between her and Mrs. Haley, the latter was bound to vote her shares for an adjournment of the meeting, or in the alternative, for a certain slate of directors. Mrs. Haley contends that she was not so bound for reason that the agreement was invalid, or at least revocable.

The two ladies entered into the agreement in 1941. It makes like provisions concerning stock of the corporate defendant and of another corporation, but in this case, we are concerned solely with the agreement as it affects the voting of stock of the corporate defendant. The agreement recites that each party was the owner "subject only to possible claims of creditors of the estates of Charles Ringling and Richard Ringling, respectively", (deceased husbands of the parties) of 300 shares of the capital stock of the defendant corporation; that in 1938 these shares had been deposited under a voting trust agreement which would terminate in 1947, or earlier, upon the elimination of certain liability of the corporation; that each party also owned 15 shares individually; that the parties had "entered into an agreement in April 1934 providing for joint action by them in matters affecting their ownership of stock and interest in" the corporate defendant; that the parties desired "to continue to act jointly in all matters relating to their stock ownership or interest in" the corporate defendant (and the other corporation). The agreement then provides as follows:

"Now, Therefore, in consideration of the mutual covenants and agreements hereinafter contained the parties hereto agree as follows:

"1. Neither party will sell any shares of stock or any voting trust certificates in either of said corporations to any other person whosoever, without first making a written offer to the other party hereto of all of the shares or voting trust certificates proposed to be sold, for the same price and upon the same terms and conditions as in such proposed sale, and allowing such other party a time of not less than 180 days from the date of such written offer within which to accept same.

"2. In exercising any voting rights to which either party may be entitled by virtue of ownership of stock or voting trust certificates held by them in either of said corporations, each party will consult and confer with the other and the parties will act jointly in exercising such voting rights in accordance with such agreement as they may reach with respect to any matter calling for the exercise of such voting rights.

"3. In the event the parties fail to agree with respect to any matter covered by paragraph 2 above, the question in disagreement shall be submitted for arbitration to Karl D. Loos, of Washington, D. C., as arbitrator and his decision thereon shall be binding upon the parties hereto. Such arbitration shall be exercised to the end of assuring for the respective corporations good management and such participation therein by the members of the Ringling family as the experience, capacity and ability of each may warrant. The parties may at any time by written agreement designate any other individual to act as arbitrator in lieu of said Loos.

"4. Each of the parties hereto will enter into and execute such voting trust agreement or agreements and such other instruments as, from time to time they may deem advisable and as they may be advised by counsel are appropriate to effectuate the purposes and objects of this agreement.

"5. This agreement shall be in effect from the date hereof and shall continue in effect for a period of ten years unless sooner terminated by mutual agreement in writing by the parties hereto.

"6. The agreement of April 1934 is hereby terminated.

"7. This agreement shall be binding upon and inure to the benefit of the heirs, executors, administrators and assigns of the parties hereto respectively." * * *

Having examined what the parties sought to provide by the agreement, we come now to defendants' contention that the voting provisions are illegal and revocable. They say that the courts of this state have definitely established the doctrine "that there can be no agreement, or any device whatsoever, by which the voting power of stock of a Delaware corporation may be irrevocably separated from the ownership of the stock, except by an agreement which complies with Section 18" of the Corporation Law, and except by a proxy coupled with an interest. They rely on Perry v. Missouri-Kansas P. L. Co., 22 Del.Ch. 33, 191 A. 823; In re Public Industrials Corporation, 19 Del. Ch. 398, reported as In re Chilson, 168 A. 82, 19 Del.Ch. 398; Aldridge v. Franco Wyoming Oil Co., 24 Del.Ch. 126, 7 A.2d 753, affirmed in 24 Del.Ch. 349, 14 A.2d 380; Belle Isle Corporation v. Corcoran, 49 A.2d 1; and contend that the doctrine is derived from Section 18 itself (Rev. Code of Del., 1935, § 2050).

In our view, neither the cases nor the statute sustain the rule for which the defendants contend. Their sweeping formulation would impugn well-recognized means by which a shareholder may effectively confer his voting rights upon others while retaining various other rights. For example, defendants' rule would apparently not permit holders of voting stock to confer upon stockholders of another class, by the device of an amendment of the certificate of incorporation, the exclusive right to vote during periods when dividends are not paid on stock of the lattter class. The broad prohibitory meaning which defendants find in Section 18 seems inconsistent with their concession that proxies coupled with an interest may be irrevocable, for the statute contains nothing about such proxies. The statute authorizes, among other things, the deposit or transfer of stock in trust for a specified purpose, namely, "vesting" in the transferee "the right to vote thereon" for a limited period; and prescribes numerous requirements in this connection. Accordingly, it seems reasonable to infer that to establish the relationship and accomplish the purpose which the statute authorizes, its requirements must be complied with. But the statute does not purport to deal with agreements whereby shareholders attempt to bind each other as to how they shall vote their shares. Various forms of such pooling agreements, as they are sometimes called, have been held valid and have been distinguished from voting trusts. [Citing cases.]

We think the particular agreement before us does not violate Section 18 or constitute an attempted evasion of its requirements, and is not illegal for any other reason. Generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed

his fellow shareholders. Heil v. Standard G. & E. Co., 17 Del.Ch. 214, 151 A. 303. The ownership of voting stock imposes no legal duty to vote at all. A group of shareholders may, without impropriety, vote their respective shares so as to obtain advantages of concerted action. They may lawfully contract with each other to vote in the future in such way as they, or a majority of their group, from time to time determine. Reasonable provisions for cases of failure of the group to reach a determination because of an even division in their ranks seem unobjectionable. The provision here for submission to the arbitrator is plainly designed as a deadlock-breaking measure, and the arbitrator's decision cannot be enforced unless at least one of the parties (entitled to cast one-half of their combined votes) is willing that it be enforced. We find the provision reasonable. It does not appear that the agreement enables the parties to take any unlawful advantage of the outside shareholder, or of any other person. It offends no rule of law or public policy of this state of which we are aware.

Legal consideration for the promises of each party is supplied by the mutual promises of the other party. The undertaking to vote in accordance with the arbitrator's decision is a valid contract. The good faith of the arbitrator's action has not been challenged and, indeed, the record indicates that no such challenge could be supported. Accordingly, the failure of Mrs. Haley to exercise her voting rights in accordance with his decision was a breach of her contract. It is no extenuation of the breach that her votes were cast for two of the three candidates directed by the arbitrator. His directions to her were part of a single plan or course of action for the voting of the shares of both parties to the agreement, calculated to utilize an advantage of joint action by them which would bring about the election of an additional director. The actual voting of Mrs. Haley's shares frustrates that plan to such an extent that it should not be treated as a partial performance of her contract.

Throughout their argument, defendants make much of the fact that all votes cast at the meeting were by the registered shareholders. The Court of Chancery may, in a review of an election, reject votes of a registered shareholder where his voting of them is found to be in violation of rights of another person. Compare: In re Giant Portland Cement Co., 21 A.2d 697 (Del.Ch.); In re Canal Construction Co., 21 Del.Ch. 135, 182 A. 545. It seems to us that upon the application of Mrs. Ringling, the injured party, the votes representing Mrs. Haley's shares should not be counted. Since no infirmity in Mr. North's voting has been demonstrated, his right to recognition of what he did at the meeting should be considered in granting any relief to Mrs. Ringling; for her rights arose under a contract to which Mr. North was not a party. With this in mind, we have concluded that the election should not be declared invalid, but that effect should be given to a rejection of the votes representing Mrs. Haley's shares. No other relief seems appropriate in this proceeding. Mr. North's vote against the motion for adjournment was sufficient to defeat it. With respect to the election of directors, the return of the inspectors should be corrected to show a rejection of Mrs. Haley's votes, and to declare the election of the six persons for whom Mr. North and Mrs. Ringling voted.

This leaves one vacancy in the directorate. The question of what to do about such a vacancy was not considered by the court below and has not been argued here. For this reason, and because an election of directors at the 1947 annual meeting (which presumably will be held in the near future) may make a determination of the question unimportant, we shall not decide it on this appeal. If a decision of the point appears important to the parties, any of them may apply to raise it in the Court of Chancery, after the mandate of this court is received there.

An order should be entered directing a modification of the order of the Court of Chancery in accordance with this opinion.

(c) *Determination of Management*

MANSON v. CURTIS.

Court of Appeals of New York, 1918. 223 N.Y. 313, 119 N.E. 559.

Action by Philip Manson against F. Kingsbury Curtis. From a judgment of the Appellate Division (171 App.Div. 954, 155 N.Y.Supp. 1123), affirming a judgment of the Special Term which overruled demurrers to defenses contained in the answer, and dismissed the complaint on the merits, plaintiff appeals. Judgment affirmed.

COLLIN, J. The action is to recover the damages arising to the plaintiff by reason of the acts of the defendant. The Special Term decided, under demurrers of the plaintiff to certain defenses alleged in the answer, that the complaint did not state facts sufficient to constitute a cause of action, and should be dismissed. The consequent judgment was affirmed by the Appellate Division.

The determinative allegations of the complaint are: In November, 1911, there existed a domestic corporation, the Bermuda-Atlantic Steamship Company. It was formed in December, 1910, as the successor of a corporation with the same name. The corporate business was operating a steamship, the Oceana, between the city of New York and the islands of Bermuda. The plaintiff had through 1911 controlled and managed the corporate business, which had been highly successful and profitable. The total outstanding shares of the capital stock were of the aggregate amount of $186,000, of which each of the plaintiff and the defendant owned in the amount of $55,000, Abel I. Culver owned in the amount of $40,000, and eight others, who became stockholders at the solicitation of the plaintiff, who "was able to control same for voting purposes," owned in the amount of $36,000. The plaintiff was a director. The defendant was a director, a lawyer, and the general counsel to the corporation, and at all the times involved had full knowledge of the corporate affairs and financial condition. An agreement, known to the defendant, existed between the plaintiff and Culver that they would act as a unit in the management of the corporate affairs, "to the end that such policy as the plaintiff might in his good judgment promulgate in the conduct and management of the said company's affairs would be acquiesced in and followed by said Culver"; that neither would dispose of any of his shares without first giving to

the other a first option to buy all or any part of the shares, and that if occasion arose Culver would vote his shares as the plaintiff voted his. The defendant requested plaintiff's permission to purchase Culver's shares, which, added to those held by the defendant, would constitute the defendant the holder of more than one-half of the outstanding shares. The plaintiff and defendant thereupon agreed, for a good and valuable consideration, as follows:

"(1) That for one year thereafter there should be no change in the business management of the business of the corporation to that theretofore carried out by plaintiff, and that the management thereof should continue in the same manner that it had in the past, and that plaintiff should continue as general manager of the corporation and shape its policy.

"(2) That any president of the corporation to be thereafter elected should be only a nominal head as president, and be no more active in conducting the affairs of the corporation than the then president, Abel I. Culver, had been, and that such president should not change, alter, molest, or interfere with plaintiff's methods of managing the corporate business affairs nor interfere with plaintiff as such general manager for said one year.

"(3) That out of defendant's stockholdings he would sell to the plaintiff and plaintiff would buy 20 shares or $2,000 thereof at par value after defendant had acquired Culver's said stock.

"(4) That the defendant and the plaintiff should each name three directors of the corporation for immediate future election (making six) and that a seventh director to be elected should be a disinterested party to be mutually agreed upon by plaintiff and defendant with whom should be deposited, and who should be the custodian of $10,000 of stock, $5,000 thereof to be carved out of the plaintiff's holdings and $5,000 out of the defendant's holdings, said $10,000 of stock to be used and voted on by such disinterested person at stockholders' meetings according to his judgment.

"(5) That the said defendant would loan to the company such fund as it immediately required to pay the expense of certain overhauling and repair charges for work which was then about to be made on the steamer Oceana, the total cost of which work was estimated at approximately twelve thousand dollars ($12,000).

"(6) The plaintiff on his part agreed to act as general manager of the corporation for one year and to conduct and manage the practical business end of the corporation according to his best ability, and to shape its policy, as he had in the past, and to purchase 20 shares of defendant's total holdings and pay defendant $2,000 therefor, and that plaintiff would name three directors of said corporation for immediate future election, and that he would cooperate with defendant in the selection of a seventh or disinterested person to be a seventh director, and carve out of this plaintiff's total holdings of stock $5,000 thereof for deposit with such disinterested person for voting purposes."

It was upon the express condition that the agreement be executed, and, in consideration of it, executed and delivered, that the plaintiff consented to the sale which was made by Culver of his shares to the defendant.

The obligations of the plaintiff under the agreement were performed by him, in so far as performance was permitted. The defendant violated the agreement, in that he refused to sell the 20 shares of the stock to plaintiff. He, through his control of dummy directors elected by his majority votes, placed all control and management of the corporate affairs in charge of a person unfit and other than plaintiff. He refused to carve out of his stockholdings $5,000 in amount for use by a disinterested party for voting purposes or to co-operate with the plaintiff in the designation of a disinterested party. The business and affairs of the corporation were consequently negligently and inefficiently carried on in particulars alleged, with the result that in June, 1912, the corporation was adjudicated a bankrupt. The defendant when making the agreement did not intend to carry it out, and intended to use his voting power in so injuring the corporate business and reducing the value of the stock that he could purchase it at a nominal price, and then sell the steamship at a large price to parties with whom he was, when the agreement was made, secretly negotiating the sale. When the agreement was made the shares of plaintiff had a market value of the sum of $215,000, and by reason of the acts of the defendant became valueless; the corporation was indebted to the plaintiff for moneys advanced in the sum of $19,582.53 and interest, which said moneys were never paid to plaintiff. Judgment in the sum of $234,-582.53 is demanded. * * *

The primal question is, Is the agreement of November, 1911, illegal and void? It does not constitute a voting trust agreement, because under it each party retains the voting power of the shares owned or to be owned by him. The right of voting is with the legal and beneficial ownership. A voting trust agreement accumulates in the hands of a person or persons shares of several owners, in trust for the purpose of voting them, in order, through the selection and election of directors, to control the corporate business and affairs. The agreement does not constitute a proxy or reciprocal proxies because it does not make either party the agent of the other. A proxy is an authority by one, having the right to do a certain thing, to another to do it. The statutes regulating voting trust agreements and the use of proxies (General Corporation Law [Consol. Laws, c. 23] §§ 23, 25, 26, 27), are therefore not applicable to the agreement.

It is not illegal or against public policy for two or more stockholders owning the majority of the shares of stock to unite upon a course of corporate policy or action, or upon the officers whom they will elect. An ordinary agreement, among a minority in number, but a majority in shares, for the purpose of obtaining control of the corporation by the election of particular persons as directors is not illegal. Shareholders have the right to combine their interests and voting powers to secure such control of the corporation and the adoption of and adhesion by it to a specific policy and course of business. Agreements upon a sufficient consideration between them, of such intendment and effect, are valid and binding, if they do not contravene any express charter or statutory provision or contemplate any fraud, oppression, or wrong against other stockholders or other illegal object. * * *

The respondent asserts and argues that the agreement before us

contravenes a statutory provision and the policy of the state, because in intent and effect it withdraws from the directors of the corporation that control and direction of the corporate affairs and business which the statutes and the law vest in and confine to them. This assertion we will now consider. The ascertainment of the substantial intent of the parties, as expressed, is the fundamental rule in the interpretation of all contracts. We must look to the agreement as a whole, to the matters with which it deals, to the circumstances under which it was made, and thereby determine the true intent and purpose of the parties; and, if such intent and purpose is reasonably within the scope of the language used, it must be taken to be a part of the agreement the same as if it were plainly expressed. People ex rel. New York Central & Hudson River R. R. Co. v. Walsh, 211 N.Y. 90, 105 N.E. 136. The fundamental and dominant intent and purpose of the agreement was that through its fulfillment there should be vested in or continue to be vested in the plaintiff solely and exclusively, for the period named, the executive administration of the affairs of the corporation. The parties agreed that through the period of one year after the making of the agreement the plaintiff should manage the corporate business and shape and control the corporate policy; that the president of the corporation should be only a nominal head and be inattentive to and noninterfering with the business or the policy or the plaintiff. Such is the clear and certain intent and effect of the paragraphs 1, 2, and 6 of the agreement. Certain allegations of the complaint are confirmatory. The prior agreement between the plaintiff and Culver, the president of the corporation, provided that:

"They act as a unit in the management of the company's affairs, to the end that such policy as the plaintiff might in his good judgment promulgate in the conduct and management of the said company's affairs would be acquiesced in and followed by said Culver."

Prior to the transfer by Culver of his stock to the defendant, the plaintiff had shaped the policy and controlled and managed the business of the corporation, and thereafter the defendant by his appointee "superseded and set aside the policy previously established and outlined by this plaintiff, and set aside and revoked his orders and his contemplated measures theretofore installed, and arranged for the future, and changed the policy theretofore established by plaintiff in all the departments of the business of said corporation." The exclusive administration by the plaintiff of the affairs of the corporation the agreement provided should continue. The plaintiff and defendant agreed by paragraph "4" of the agreement that they would unite in the choice and election of six of the seven directors, a stipulation standing alone innocent and legal. They did not intend in so stipulating to destroy or affect the purpose and intent which induced the agreement as a whole. Manifestly, the agreement would not have been made for the purpose of effecting that stipulation alone. That stipulation was subordinate. The fundamental and dominant purpose and intent of the parties which necessitated and provided for a passive president of the board of directors necessitated likewise passive directors. The conditions which the parties wished to meet and their intent necessitated and contemplated the selecting of directors who

should remain passive or mechanical to the will and word of the plaintiff. The management of the affairs of the corporation by its board of directors and the management of them by the plaintiff as contemplated by the agreement are irreconcilable and mutually destructive.

The prerogatives and functions of the directors of a stock corporation are sufficiently defined and established. The affairs of every corporation shall be managed by its board of directors (General Corporation Law, [Consol. Laws, c. 23] § 34), subject, however, to the valid by-laws adopted by the stockholders (section 11, subd. 5; Stock Corporation Law [Consol. Laws, c. 59] § 30). In corporate bodies, the powers of the board of directors are, in a very important sense, original and undelegated. The stockholders do not confer, nor can they revoke, those powers. They are derivative only in the sense of being received from the state in the act of incorporation. The directors convened as a board are the primary possessors of all the powers which the charter confers, and like private principals they may delegate to agents of their own appointment the performance of any acts which they themselves can perform. The recognition of this principle is absolutely necessary in the affairs of every corporation whose powers are vested in a board of directors. Hoyt v. Thompson's Executor, 19 N.Y. 207, 216. All powers directly conferred by statute, or impliedly granted, of necessity, must be exercised by the directors who are constituted by the law as the agency for the doing of corporate acts. In the management of the affairs of the corporation, they are dependent solely upon their own knowledge of its business and their own judgment as to what its interests require. Beveridge v. New York Elevated R. R. Co., 112 N.Y. 1, 19 N.E. 489, 2 L.R.A. 648. While the ordinary rules of law relating to an agent are applicable in considering the acts of a board of directors in behalf of a corporation when dealing with third persons, the individual directors making up the board are not mere employés, but a part of an elected body of officers constituting the executive agents of the corporation. They hold such office charged with the duty to act for the corporation according to their best judgment, and in so doing they cannot be controlled in the reasonable exercise and performance of such duty. As a general rule, the stockholders cannot act in relation to the ordinary business of the corporation, nor can they control the directors in the exercise of the judgment vested in them by virtue of their office. The relation of the directors to the stockholders is essentially that of trustee and cestui que trust. The peculiar relation that they bear to the corporation and the owners of its stock grows out of the inability of the corporation to act except through such managing officers and agents. The corporation is the owner of the property, but the directors in the performance of their duty possess it, and act in every way as if they owned it. People ex rel. Manice v. Powell, 201 N.Y. 194, 94 N.E. 634. Directors are the exclusive, executive representatives of the corporation, and are charged with the administration of its internal affairs and the management and use of its assets. Pollitz v. Wabash R. R. Co., 207 N.Y. 113, 100 N.E. 721. Clearly the law does not permit the stockholders to create a sterilized board of directors. Corporations are the creatures of the state, and must comply with the exactions and

regulations it imposes. We conclude that the agreement here is illegal and void, and its violation is not a basis for a cause of action. Jackson v. Hooper, 76 N.J.Eq. 592, 75 Atl. 568, 27 L.R.A.,N.S., 658. This conclusion is not affected by the allegation that the defendant when making the agreement did not intend to carry it out. The illegality of the agreement was, the law holds, known by both parties. There is no deceit in the intention of the defendant to refrain from performing the agreement, performance of which would violate the law. * * *

The good faith or intention of the parties, or of the plaintiff, in entering into the agreement, does not purge it of the illegality. The doctrine that an advantageous or desirable end justifies unlawful means to its accomplishment has neither foothold nor recognition in the law. The rule that all the stockholders by their universal consent may do as they choose with the corporate concerns and assets, provided the interests of creditors are not affected, because they are the complete owners of the corporation, cannot be invoked here. The fact that the plaintiff was able to control for voting purposes the eight minority stockholders, who were not parties to the agreement, if proved, would not make them parties or establish their consent to the agreement. They might vote in electing directors as the plaintiff requested without affecting their rights as stockholders. They could thereafter insist that the directors so chosen should assume and perform the duties and responsibilities which the law imposes.

The judgment should be affirmed, with costs.

McQUADE v. STONEHAM et al.

Court of Appeals of New York, 1934. 263 N.Y. 323, 189 N.E. 234.

Action by Francis X. McQuade against Charles A. Stoneham and another. Judgment for plaintiff for $42,827,38, and other relief (142 Misc. 842, 256 N.Y.S. 431) was unanimously affirmed by the Appellate Division (238 App.Div. 827, 262 N.Y.S. 966), and plaintiff appeals by permission.

Reversed and complaint dismissed.

POUND, CHIEF JUDGE. The action is brought to compel specific performance of an agreement between the parties, entered into to secure the control of National Exhibition Company, also called the Baseball Club (New York Nationals or "Giants"). This was one of Stoneham's enterprises which used the New York polo grounds for its home games. McGraw was manager of the Giants. McQuade was at the time the contract was entered into a city magistrate. He resigned December 8, 1930.

Defendant Stoneham became the owner of 1,306 shares, or a majority of the stock of National Exhibition Company. Plaintiff and defendant McGraw each purchased 70 shares of his stock. Plaintiff paid Stoneham $50,338.10 for the stock he purchased. As a part of the transaction, the agreement in question was entered into. It was dated May 21, 1919. Some of its pertinent provisions are

"VIII. The parties hereto will use their best endeavors for the purpose of continuing as directors of said Company and as officers thereof the following:

"Directors:

"Charles A. Stoneham,
"John J. McGraw,
"Francis X. McQuade

"—with the right to the party of the first part [Stoneham] to name all additional directors as he sees fit:

"Officers:

"Charles A. Stoneham, President,
"John J. McGraw, Vice-President,
"Francis X. McQuade, Treasurer.

"IX. No salaries are to be paid to any of the above officers or directors, except as follows:

"President	$45,000
"Vice-President	7,500
"Treasurer	7,500

"X. There shall be no change in said salaries, no change in the amount of capital, or the number of shares, no change or amendment of the by-laws of the corporation or any matters regarding the policy of the business of the corporation or any matters which may in anywise affect, endanger or interfere with the rights of minority stockholders, excepting upon the mutual and unanimous consent of all of the parties hereto. * * *

"XIV. This agreement shall continue and remain in force so long as the parties or any of them or the representative of any, own the stock referred to in this agreement, to wit, the party of the first part, 1,166 shares, the party of the second part 70 shares and the party of the third part 70 shares, except as may otherwise appear by this agreement. * * *"

In pursuance of this contract Stoneham became president and McGraw vice president of the corporation. McQuade became treasurer. In June, 1925, his salary was increased to $10,000 a year. He continued to act until May 2, 1928, when Leo J. Bondy was elected to succeed him. The board of directors consisted of seven men. The four outside of the parties hereto were selected by Stoneham and he had complete control over them. At the meeting of May 2, 1928, Stoneham and McGraw refrained from voting, McQuade voted for himself, and the other four voted for Bondy. Defendants did not keep their agreement with McQuade to use their best efforts to continue him as treasurer. On the contrary, he was dropped with their entire acquiescence. At the next stockholders' meeting he was dropped as a director although they might have elected him.

The courts below have refused to order the reinstatement of McQuade, but have given him damages for wrongful discharge, with a right to sue for future damages.

The cause for dropping McQuade was due to the falling out of friends. McQuade and Stoneham had disagreed. The trial court has found in substance that their numerous quarrels and disputes did not affect the orderly and efficient administration of the business of the

corporation; that plaintiff was removed because he had antagonized the dominant Stoneham by persisting in challenging his power over the corporate treasury and for no misconduct on his part. The court also finds that plaintiff was removed by Stoneham for protecting the corporation and its minority stockholders. We will assume that Stoneham put him out when he might have retained him, merely in order of get rid of him.

Defendants say that the contract in suit was void because the directors held their office charged with the duty to act for the corporation according to their best judgment and that any contract which compels a director to vote to keep any particular person in office and at a stated salary is illegal. Directors are the exclusive executive representatives of the corporation, charged with administration of its internal affairs and the management and use of its assets. They manage the business of the corporation. (General Corporation Law, Consol.Laws c. 23, § 27.) "An agreement to continue a man as president is dependent upon his continued loyalty to the interests of the corporation." Fells v. Katz, 256 N.Y. 67, 72, 175 N.E. 516, 517. So much is undisputed.

Plaintiff contends that the converse of this proposition is true and that an agreement among directors to continue a man as an officer of a corporation is not to be broken so long as such officer is loyal to the interests of the corporation and that, as plaintiff has been found loyal to the corporation, the agreement of defendants is enforceable.

Although it has been held that an agreement among stockholders whereby it is attempted to divest the directors of their power to discharge an unfaithful employee of the corporation is illegal as against public policy (Fells v. Katz, supra), it must be equally true that the stockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of of their office to elect officers and fix salaries. Their motives may not be questioned so long as their acts are legal. The bad faith or the improper motives of the parties does not change the rule. Manson v. Curtis, 223 N.Y. 313, 324, 119 N.E. 559, Ann.Cas.1918E, 247. Directors may not by agreements entered into as stockholders abrogate their independent judgment. Creed v. Copps, 103 Vt. 164, 152 A. 369, 71 A.L.R. 1287, annotated.

Stockholders may, of course, combine to elect directors. That rule is well settled. As Holmes, C. J., pointedly said (Brightman v. Bates, 175 Mass. 105, 111, 55 N.E. 809, 811): "If stockholders want to make their power felt, they must unite. There is no reason why a majority should not agree to keep together." The power to unite is, however, limited to the election of directors and is not extended to contracts whereby limitations are placed on the power of directors to manage the business of the corporation by the selection of agents at defined salaries.

The minority shareholders whose interests McQuade says he has been punished for protecting, are not, aside from himself, complaining about his discharge. He is not acting for the corporation or for them in this action. It is impossible to see how the corporation has been injured by the substitution of Bondy as treasurer in place of Mc-

Quade. As McQuade represents himself in this action and seeks redress for his own wrongs, "we prefer to listen to [the corporation and the minority stockholders] before any decision as to their wrongs." Faulds v. Yates, 57 Ill. 416, 417, 11 Am.Rep. 24.

It is urged that we should pay heed to the morals and manners of the market place to sustain this agreement and that we should hold that its violation gives rise to a cause of action for damages rather than base our decision on any outworn notions of public policy. Public policy is a dangerous guide in determining the validity of a contract and courts should not interfere lightly with the freedom of competent parties to make their own contracts. We do not close our eyes to the fact that such agreements, tacitly or openly arrived at, are not uncommon, especially in close corporations where the stockholders are doing business for convenience under a corporate organization. We know that majority stockholders, united in voting trusts, effectively manage the business of a corporation by choosing trustworthy directors to reflect their policies in the corporate management. Nor are we unmindful that McQuade has, so the court has found, been shabbily treated as a purchaser of stock from Stoneham. We have said: "A trustee is held to something stricter than the morals of the market place" (Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546, 62 A.L.R. 1), but Stoneham and McGraw were not trustees for McQuade as an individual. Their duty was to the corporation and its stockholders, to be exercised according to their unrestricted lawful judgment. They were under no legal obligation to deal righteously with McQuade if it was against public policy to do so.

The courts do not enforce mere moral obligations, nor legal ones either, unless some one seeks to establish rights which may be waived by custom and for convenience. We are constrained by authority to hold that a contract is illegal and void so far as it precludes the board of directors, at the risk of incurring legal liability, from changing officers, salaries, or policies or retaining individuals in office, except by consent of the contracting parties. On the whole, such a holding is probably preferable to one which would open the courts to pass on the motives of directors in the lawful exercise of their trust. * * *

The judgment of the Appellate Division and that of the Trial Term should be reversed and the complaint dismissed, with costs in all courts.

CLARK v. DODGE

Court of Appeals of New York, 1936. 269 N.Y. 410, 199 N.E. 641.

Action by David H. Clark against John L. Dodge and others, wherein defendants filed a counterclaim. From an order of the Appellate Division, Second Department, entered on October 10, 1934, dismissing the complaint (242 App.Div. 728, 274 N.Y.S. 677), plaintiff appeals.

Judgment of Appellate Division reversed and order of Special Term affirmed.

CROUCH, JUDGE. The action is for the specific performance of a contract between the plaintiff, Clark, and the defendant Dodge, relating to the affairs of the two defendant corporations. To the complaint

a joint answer by the three defendants was interposed, consisting of denials and a separate defense and counterclaim. To the separate defense and counterclaim a reply was made. The defendant then moved under rule 112 of the Rules of Civil Practice, and under sections 476, 96, and 279 of the Civil Practice Act, to dismiss the complaint. The motion was made "on the pleadings in this action and the admissions of the plaintiff" in two affidavits submitted by him on a prior motion in the action. The alleged admissions are equivocal at best, and clearly were not "intended to be treated as a part of a pleading or made to avoid some question arising on the pleadings." Lloyd v. R. S. M. Corporation, 251 N.Y. 318, 320, 167 N.E. 456. We shall deal therefore, with the questions here presented in the light of the facts most favorable to plaintiff appearing in the pleadings only.

Those facts, briefly stated, are as follows: The two corporate defendants are New Jersey corporations manufacturing medicinal preparations by secret formulæ. The main office, factory, and assets of both corporations are located in the state of New York. In 1921, and at all times since, Clark owned 25 per cent. and Dodge 75 per cent. of the stock of each corporation. Dodge took no active part in the business, although he was a director, and through ownership of their qualifying shares, controlled the other directors of both corporations. He was the president of Bell & Co., Inc., and nominally general manager of Hollings-Smith Company, Inc. The plaintiff, Clark, was a director and held the offices of treasurer and general manager of Bell & Co., Inc., and also had charge of the major portion of the business of Hollings-Smith Company, Inc. The formulæ and methods of manufacture of the medicinal preparations were known to him alone. Under date of February 15, 1921, Dodge and Clark, the sole owners of the stock of both corporations, entered into a written agreement under seal, which after reciting the stock ownership of both parties, the desire of Dodge that Clark should continue in the efficient management and control of the business of Bell & Co., Inc., so long as he should "remain faithful, efficient and competent to so manage and control the said business"; and his further desire that Clark should not be the sole custodian of a specified formula, but should share his knowledge thereof and of the method of manufacture with a son of Dodge, provided, in substance, as follows: That Dodge during his lifetime and, after his death, a trustee to be appointed by his will, would so vote his stock and so vote as a director that the plaintiff (a) should continue to be a director of Bell & Co., Inc.; and (b) should continue as its general manager so long as he should be "faithful, efficient and competent"; (c) should during his life receive one-fourth of the net income of the corporations either by way of salary or dividends; and (d) that no unreasonable or incommensurate salaries should be paid to other officers or agents which would so reduce the net income as materially to affect Clark's profits. Clark on his part agreed to disclose the specified formula to the son and to instruct him in the details and methods of manufacture; and, further, at the end of his life to bequeath his stock—if no issue survived him—to the wife and children of Dodge.

It was further provided that the provisions in regard to the division of net profits and the regulation of salaries should also apply to the Hollings-Smith Company.

The complaint alleges due performance of the contract by Clark and breach thereof by Dodge in that he has failed to use his stock control to continue Clark as a director and as general manager, and has prevented Clark from receiving his proportion of the income, while taking his own, by causing the employment of incompetent persons at excessive salaries, and otherwise.

The relief sought is reinstatement as director and general manager and an accounting by Dodge and by the corporations for waste and for the proportion of net income due plaintiff, with an injunction against further violations.

The only question which need be discussed is whether the contract is illegal as against public policy within the decision in McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234, upon the authority of which the complaint was dismissed by the Appellate Division.

"The business of a corporation shall be managed by its board of directors." General Corporation Law (Consol.Laws, c. 23) § 27. That is the statutory norm. Are we committed by the McQuade Case to the doctrine that there may be no variation, however slight or innocuous, from that norm, where salaries or policies or the retention of individuals in office are concerned? There is ample authority supporting that doctrine. E. g., West v. Camden, 135 U.S. 507, 10 S.Ct. 838, 34 L.Ed. 254; Jackson v. Hooper, 76 N.J.Eq. 592, 75 A. 568, 27 L.R.A., N.S., 658. But cf. Salomon v. Salomon & Co., [1897] A.C. 22, 44, and something may be said for it, since it furnishes a simple, if arbitrary, test. Apart from its practical administrative convenience, the reasons upon which it is said to rest are more or less nebulous. Public policy, the intention of the Legislature, detriment to the corporation, are phrases which in this connection mean little. Possible harm to bona fide purchasers of stock or to creditors or to stockholding minorities have more substance; but such harms are absent in many instances. If the enforcement of a particular contract damages nobody—not even, in any perceptible degree, the public—one sees no reason for holding it illegal, even though it impinges slightly upon the broad provision of section 27. Damage suffered or threatened is a logical and practical test, and has come to be the one generally adopted by the courts. See 28 Columbia Law Review 366, 372. Where the directors are the sole stockholders, there seems to be no objection to enforcing an agreement among them to vote for certain people as officers. There is no direct decision to that effect in this court, yet there are strong indications that such a rule has long been recognized. The opinion in Manson v. Curtis, 223 N.Y. 313, 325, 119 N.E. 559, 562, Ann.Cas.1918E, 247, closed its discussion by saying: "The rule that all the stockholders by their universal consent may do as they choose with the corporate concerns and assets, provided the interests of creditors are not affected, because they are the complete owners of the corporation, cannot be invoked here." That was because all the stockholders were not parties to the agreement there in question. So, where the public was not affected, "the parties in interest, might, by their original agreement of incorporation, limit their respective rights and powers," even where there was a conflicting statutory standard. * * *

Except for the broad dicta in the McQuade opinion, we think there can be no doubt that the agreement here in question was legal and that

the complaint states a cause of action. There was no attempt to sterilize the board of directors, as in the Manson and McQuade Cases. The only restrictions on Dodge were (a) that as a stockholder he should vote for Clark as a director—a perfectly legal contract; (b) that as director he should continue Clark as general manager, so long as he proved faithful, efficient, and competent—an agreement which could harm nobody; (c) that Clark should always receive as salary or dividends one-fourth of the "net income." For the purposes of this motion, it is only just to construe that phrase as meaning whatever was left for distribution after the directors had in good faith set aside whatever they deemed wise; (d) that no salaries to other officers should be paid, unreasonable in amount or incommensurate with services rendered—a beneficial and not a harmful agreement.

If there was any invasion of the powers of the directorate under that agreement, it is so slight as to be negligible; and certainly there is no damage suffered by or threatened to anybody. The broad statements in the McQuade opinion, applicable to the facts there, should be confined to those facts.

The judgment of the Appellate Division should be reversed and the order of the Special Term affirmed, with costs in this court and in the Appellate Division.

Judgment accordingly.

ODMAN v. OLESON et al.

Supreme Judicial Court of Massachusetts, 1946. 319 Mass. 24, 64 N.E.2d 439.

Action of tort by Nelson Odman against Olaf E. Oleson and others to recover damages for alleged fraud of defendants in depriving plaintiff of valuable property rights in a corporation that were allegedly his under a certain contract. Demurrers of the defendants to the declaration were sustained, and plaintiff appeals under G.L. (Ter.Ed.) c. 231, § 96.

Order sustaining demurrers affirmed, and judgment for defendants.

LUMMUS, JUSTICE. The plaintiff in this action of tort alleges in a single count that by fraud he was deprived of valuable rights in The Framanco Company, a Massachusetts corporation, that were his under a contract executed by all the parties except the defendants Epstein and Ramsey on August 21, 1942. After that contract was made, the defendants Olaf E. Oleson and his wife Mary E. Oleson owned four hundred seventy-five shares, the plaintiff owned three hundred forty-two shares, the defendant Edward T. Edmands owned one hundred thirty-three shares, and the defendant J. Haller Ramsey owned fifty shares, the entire capital stock being one thousand shares.

The contract of August 21, 1942, which was signed by all the stockholders except Ramsey, was an attempt to control the future action of the stockholders and directors through the agreement of the parties to it to vote in favor of an elaborate program therein set forth. Edmands and Oleson were to be two of four directors, and the plaintiff and a nominee of his were to be the other two. The plaintiff was to be clerk vice-president and assistant treasurer at an annual salary

of $9,360. The rights of the parties under the agreement were to continue as long as they should remain connected with the company.

The declaration alleges that the defendants conspired to defraud him of his contract rights by purchasing in the name of Olaf E. Oleson the fifty shares of stock owned by Ramsey. Then the defendants caused the by-laws to be amended by increasing the number of directors to five, and elected Mary E. Oleson as the fifth director. The plaintiff was induced not to take legal action to prevent the change by the false representations of Oleson and Edmands that nothing would be done in derogation of the plaintiff's contract rights. The plaintiff was afterwards displaced as clerk and vice-president and assistant treasurer of the corporation, and was not paid the salary promised him in the contract.

Demurrers of the defendants were sustained, and the plaintiff appealed to this court under G.L. (Ter.Ed.) c. 231, § 96. Keljikian v. Star Brewing Co., 303 Mass. 53, 61, 20 N.E.2d 465.

The demurrers were rightly sustained. There was one stockholder not a party to the contract who might be injuriously affected by it. That distinguishes the case from Hayden v. Beane, 293 Mass. 347, 199 N.E. 755. The contract was not restricted as to time, in which respect if not in others the case differs from Mansfield v. Lang, 293 Mass. 386, 200 N.E. 110. The contract by its terms purported to control the conduct of some of the parties as directors, in which capacity they were in all respects fiduciaries for the corporation (Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 410, 411, 8 N.E.2d 895), and not merely their conduct as stockholders, differing in that respect from Brightman v. Bates, 175 Mass. 105, 55 N.E. 809, and Sagalyn v. Meekins, Packard & Wheat, Inc., 290 Mass. 434, 440, 195 N.E. 769, to say nothing of the difference in the contracts which was pointed out in Hellier v. Achorn, 255 Mass. 273, 281, 151 N.E. 305, 45 A.L.R. 788.

Although a stockholder is not in general a fiduciary in his relations to the corporation (Bell v. Fred T. Ley & Co., Inc., 278 Mass. 60, 75, 179 N.E. 294; Mairs v. Madden, 307 Mass. 378, 30 N.E.2d 242, 132 A.L.R. 256; Eno Systems, Inc., v. Eno, 311 Mass. 334, 341, 41 N.E.2d 17), a contract is void as against public policy which takes away even from stockholders freedom to use their judgment as to the best interests of the corporation. [Citing cases.]

Other possible objections to the declaration need not be considered.

Order sustaining demurrers affirmed.

Judgment for the defendants.

5. STOCKHOLDERS RESPONSIBILITY TO CORPORATION AND EACH OTHER

NOTE

Almost all that is left of the stockholder's "ownership" is his right to dividends if as and when declared; and his right to vote. This voting right is his only direct connection with the aggregate of property and operations and personalities which makes up a corporation.

And is his vote entirely his own? May he cast it or alienate it in complete disregard of his fellows—or must he be a "good citizen" in the corporate community?

Courts talk the language of complete freedom of action—up to a point. Faced with certain abuses, they depart from the rule that a stockholder need consult only his self-interest, and impose responsibilities on him. The cases trace the range of limitation or responsibility marked out as situations have arisen.

WINDMULLER v. STANDARD DISTILLING & DISTRIBUTING CO.

Circuit Court of the United States, D. New Jersey, 1902. 114 F. 491.

KIRKPATRICK, DISTRICT JUDGE. The complainants are the holders of certain shares of the first and second preferred stock of the Spirits Distributing Company, a corporation organized under the laws of the state of New Jersey, upon which the Standard Distilling & Distributing Company have guaranteed a dividend of 6 per cent. upon the first preferred, and 2 per cent. upon the second preferred, stock, during the existence of the said Spirits Distributing Company. * * *

In June, 1899, the Distilling Company of America was organized, and it became the owner of $22,742,750, par value, of the $24,000,000, par value, of the stock of the Standard Company, above referred to. It also became the owner, by purchase, of $2,592,650, par value, of the first and second preferred stock of the Spirits Distributing Company; so that at the time of the filing of this bill the stock of the Spirits Distributing Company was held as follows: By the Distilling Company of America, first and second preferred, $2,592,650; by the Standard Company (of which the Distilling Company, as has been said, owned nearly all the stock), $3,675,000 common stock; leaving outstanding stock of all kinds to the amount of $232,350, of which the complainants hold but 1,524 shares, 324 of which is first preferred, and 1,200 second preferred.

At a meeting of the board of directors of the Distributing Company it was resolved that, in the judgment of the directors, it was most advisable and for the benefit of the corporation that it should be dissolved. In accordance with the general corporation act of New Jersey, a meeting of the stockholders was called to vote upon the propriety of adopting such a course. The prayer of the complainants' bill is that the Standard Company may be enjoined from voting upon its $3,675,000, par value, common stock in favor of said proposition, because it has guaranteed the dividends on the stock of the Distributing Company as aforesaid, and that the Distilling Company be enjoined from voting upon its $2,592,650, par value, of first and second preferred stock, which it has purchased and owns, because it also owns a majority of the stock of the Standard Company, which is the guarantor thereof. That is to say, however advisable and for the benefit of the corporation it may be that the same should be dissolved, yet it cannot be done because two-thirds of the stockholders whose votes are necessary to accomplish such result are disqualified from voting by reason of their interest in the cancellation of a guaranty which the complainants now conceive to be adverse to their interests. To carry the doctrine to its logical conclusion would be to hold that, if the guarantor's company and those who own a majority of the stock in the guarantor's company should also be the owners of all the stock in the

guaranteed company except one share, the owner of that one share could prevent the dissolution of the company forever, if its charter were perpetual, or compel its operation at a loss until all its assets were wasted or consumed. Section 51 of the general corporation act of New Jersey provides that any corporation organized under it "may hold the shares of any other corporation of that or any other state," and while the owner thereof, "may exercise all rights, powers, and privileges of ownership, including the right to vote thereon." In respect to the voting power, the rights of a corporation are identical with the rights of an individual, and only those reasons would operate to prevent a corporation from voting on its stock which would effect the same object if the stock was held by an individual.

I have not been referred to any authority which holds that one stockholder is in any sense a trustee for other stockholders, or that he is debarred from voting on his stock according to what he may conceive to be his interest, or in a way which may result in a benefit to himself, and which other stockholders may not enjoy. Directors by whomsoever elected, are the representatives of all the stockholders, and, as such, are charged with the duty of administering the affairs of the company for the equal benefit of their cestuis que trustent. But the doctrine is new that the stockholders are trustees one for another, or that an interest of one stockholder, which in the judgment of another stockholder may seem to be adverse to his own, can operate to prevent him from voting on his own stock as he sees fit.

In the case of Transportation Co. v. Beatty, 12 App.Cas. 589, one of the directors owned a majority of the stock of the corporation, and at a meeting of the shareholders, by reason of his majority, he caused to be passed a resolution ratifying a contract to sell to the company, upon advantageous terms, a vessel belonging to himself. In passing upon the propriety of his right to vote, the court said:

"Unless some provision to the contrary is to be found in the charter or other instrument by which the company is incorporated, the resolution of a majority of the shareholders, duly convened, upon any question with which the company is legally competent to deal, is binding upon the minority, and consequently upon the company; and every shareholder has a perfect right to vote upon any such question, although he may have a personal interest in the subject-matter opposed to or different from the general or particular interests of the company. A shareholder has a perfect right to exercise his voting power in such manner as to secure the election of directors whose views on policy agree with his own, and to support those views at any shareholders' meeting."

The court cannot be called upon to manage the internal affairs of corporations, or to determine whether this or that stockholder is disqualified from voting upon one or another question which may be presented to the stockholders for their consideration by reason of his own interest. If the directors, who are the trustees of all, conspire with a few or some of the stockholders to deprive the others of their property, the court will interfere to see that justice is done. The court will not permit the directors to divert the business of the corporation so that a sale and sacrifice of its assets will become obliga-

tory, and the distribution of the proceeds unequal among its shareholders. This is the doctrine which is at the foundation of the opinion in the case of Farmers' Loan & Trust Co. v. New York & N. R. Co., 150 N.Y. 410, 44 N.E. 1043, 34 L.R.A. 76, 55 Am.St.Rep. 689, and Ervin v. Navigation Co. (C.C.) 27 F. 625.

No case has been brought to the attention of the court where any stockholder has been deprived of his right to vote on his stock in such a way as may, in his opinion, best subserve his own interests. He may vote his stock as he pleases for the purpose of his own interest, but he may not sell, or cause to be sold, assets and keep the consideration. Menier v. Telegraph Works, 9 Ch.App. 350. In Gamble v. Water Co. (N.Y.) 25 N.E. 201, a stockholder's right to vote was questioned because of interest, and the court of appeals reversing the decision of the lower court, said:

"A shareholder has a legal right, at a meeting of shareholders, to vote upon a measure, even though he has a personal interest therein separate from other shareholders. At such a meeting each shareholder represents himself and his own interests, and he in no sense acts as the representative of others. The law of self-interest has at such time very great and proper sway. There can be little doubt, too, that at such meetings those who do vote on their own stock vote upon it in the light solely of their own interest, or at least in what they conceive to be their own interest."

In the case at bar the court is not in possession of facts which would enable them to determine whether the interests of the corporation, as distinct from the interests of the individual shareholders, require that it should be dissolved. Under the general corporation act of the state of New Jersey, any corporation may be dissolved whenever in the judgment of the board of directors it shall be deemed advisable and most for the benefit of such corporation that it should be dissolved; provided that, at a meeting of the stockholders called for the purpose of passing upon the propriety of such dissolution, two-thirds in interest of all the stockholders shall consent thereto. Laws 1896, c. 185. There is no provision in the law which authorizes the court to review the judgment of the directors as to the advisability of dissolution. And in 4 Thomp.Corp. § 4443, it is said:

"It is believed that no case can be found in which a court of equity has granted an injunction at the suit of a minority stockholder against the majority to prevent them from discontinuing the business of the corporation and winding up its affairs."

It is urged in behalf of the complainants that it would be inequitable to allow the Standard Company, after having received a valuable consideration for their guaranty, by their own act to dissolve the corporation, and thereby cancel its said obligation. But it must be remembered that, in the proposition made to the stockholders of the Distributing Company by Mr. Eicks, Mr. Eicks said that, if such stockholders would consent to a reduction of the rate of their dividends, he would procure the Standard Company to guaranty and pay, during the existence of the company, dividends at the rate of 6 per cent. per annum on the first preferred, and 2 per cent. per annum on the second preferred stock of the Distributing Company. To that proposi-

tion the complainants assented, and they did so with the knowledge that at any time, under the laws of the state of New Jersey, two-thirds in interest of the shareholders of the Distributing Company could dissolve the company, and thereby put it out of existence. They are in no position to complain if, in accordance with the terms of the agreement, the Standard Company and the Distilling Company, who are the stockholders of the Distributing Company, propose to put an end to their liability thereunder.

Other reasons are urged in behalf of the defendant company why this injunction should not be granted, but, having come to the conclusion that the Standard Company and the Distilling Company of America are not prohibited from exercising their right to vote at the stockholders' meeting upon the question of dissolution submitted by the board of directors, it is not necessary to enter into any discussion of them.

For the reasons already stated, therefore, the rule to show cause in this case must be discharged.

WHEELER v. ABILENE NAT. BANK BLDG. CO.

Circuit Court of Appeals of the United States, 1908.
159 F. 391, 16 L.R.A.,N.S., 892, 14 Ann.Cas. 1917.

SANBORN, CIRCUIT JUDGE. Two holders of the minority of the stock of the Abilene National Bank Building Company, a corporation, brought a suit in the court below to avoid a sale of all the property of the corporation to Hiland Southworth, who was the president of the corporation, its creditor, one of its board of directors, and the holder of the majority of its stock. * * *

The following facts appear from the pleadings and the finding of the master: The only property of the corporation was a lot and building in Abilene, which was sold to Southworth, the holder of the majority of stock of the company, in June, 1904. The fair value of this property was $2,500. The corporation had power to buy, sell, and deal in real estate, and it had issued 173 shares of stock. The complainants, who lived in the state of Vermont, owned 46 shares. The defendant Southworth, who resided in Abilene, in the state of Kansas, owned 101 shares. The defendants Humphrey, Malott, Ella M. Southworth, the wife of Southworth, and Stella Duckworth, his stenographer, held 1 share each which Southworth had transferred to them to qualify them to act as directors. Southworth was the president. Stella Duckworth was the secretary. Southworth, Mrs. Southworth, Stella Duckworth, Humphrey, and Malott constituted the board of directors. The corporation owed Southworth, but its property was of greater value than the amount of its debts. Malott and Humphrey inquired, and found that $2,500 was a fair price for the property, and the board sold and the corporation conveyed it to Southworth for that amount, paid the debts of the corporation, declared a dividend on its stock, and remitted the proper amount to each stockholder; but the complainants refused to accept their dividends. In July, 1904, Wheeler, one of the complainants, objected to this sale and

told Southworth he would give $3,500 for the property. In August, 1904, Southworth and wife conveyed the lot and building to the corporation. On August 29, 1904, Wheeler sent a letter to Stella Duckworth, the secretary of the corporation, which she received, wherein he wrote that if the property was offered for sale he desired an opportunity to bid upon it; but this letter was never brought to the attention of any meeting of the stockholders or of any meeting of the directors. On November 10, 1904, the board of directors accepted the reconveyance of the property. Malott said he had made diligent inquiry regarding its value, and that he could find no one who would place a higher value than $2,500 upon it. Southworth offered $2,500, the board unanimously voted to sell it to him for that price and the corporation again conveyed it to him. Legal notice that there would be an annual meeting of the stockholders on December 6, 1904, to elect a board of directors and to transact such other business as might come before the meeting, was given. There were present at that meeting Hurd, Humphrey, Malott, Stella Duckworth, and Southworth, who together represented 111 shares of stock, and they voted unanimously to confirm the sale to Southworth for $2,500. Southworth and the other directors acted in good faith. Upon these facts the court below dismissed the bill, and the complainants appealed.

The question which this case presents is: May the holder of the majority of the stock of a corporation make a sale to himself, unassailable in equity, of all the property of the corporation for its fair value, when he knows that that value is only five-sevenths of the amount which the corporation can obtain for it. It is not material to the determination of this issue whether the notice of the stockholders' meeting specified, or failed to state, that the question of the confirmation of the sale to Southworth would be there considered, or whether or not the other proceedings of the defendants complied with the requirements of the law; and for the purposes of this decision it will be conceded, but it is not decided, that all the proceedings of the parties and of the corporation were in strict accordance with the forms of law. The objection to this sale lies deeper. It is that it was violative of the duty of a fiduciary.

A corporation holds its property in trust for its stockholders. The stockholders have a joint interest in the same property and in the same title. Community of interest in a common property or title imposes a community of duty and a mutual obligation to do nothing to impair either. It creates such a fiducial relation as makes it inequitable for any of those who thus share in the common property to do anything to or with it for their own profit, to the detriment of others who have the same rights. Jackson v. Ludeling, 21 Wall. 616, 622, 22 L.Ed. 492; Jones v. Missouri Edison Electric Co., 144 F. 765, 771, 75 C.C.A. 631, 637; Booker v. Crocker, 132 F. 7, 8, 65 C.C.A. 627, 628.

The holder of the majority of the stock of a corporation has the power, by the election of biddable directors and by the vote of his stock, to do everything that the corporation can do. His power to control and direct the action of the corporation places him in its shoes, and constitutes him the actual, if not the technical, trustee for the holders of the minority of the stock. He draws to himself and uses

all the powers of the corporation. In effect he holds an irrevocable power of attorney from the minority stockholders to manage and to sell the property of the corporation, for himself and for them. Times, places, and notices of meetings of the directors and of meetings of stockholders become of secondary importance, because the presence, the vote, and the protest of holders of the minority of the stock are unavailing against the will of the holder of the majority. They can act and contract regarding the corporate property, they can preserve and protect their interests in it, only through him and through the courts.

This devolution of unlimited power imposes on a single holder of the majority of the stock a correlative duty, the duty of a fiduciary or agent, to the holders of the minority of the stock, who can act only through him, the duty to exercise good faith, care, and diligence to make the property of the corporation produce the largest possible amount, to protect the interests of the holders of the minority of the stock, and to secure and pay over to them their just proportion of the income and of the proceeds of the corporate property. Any sale of the property of the corporation by him to himself for less than he could obtain for it from another, or any other act in his interest to the detriment of the holders of the minority of the stock, becomes a breach of duty and of trust, renders the sale or act voidable at the election of the minority stockholders, and invokes plenary relief from a court of chancery. * * *

It is the duty of the master of the corporation who sells its property to procure the highest possible price for it (Jackson v. Ludeling, 21 Wall. 616, 625, 22 L.Ed. 492); and, if he sells it to himself for less, the sale is voidable by the holders of the minority of the stock at their option, although he paid the fair market value for it. Miller v. Brown, 1 Neb. (Unof.) 754, 95 N.W. 797.

The principles which have been briefly reviewed and the decisions which have been cited in support of them spring from the law's jealous care of the fiduciary relations, from its persistent endeavor to prevent a conflict of duty and interest by removing from every person in such a relation every possible temptation to advance his own welfare in disregard of his duty to his correlate, by avoiding every transaction in which he has endeavored to do so. They have been repeatedly discussed and affirmed in the Supreme Court and in this court, and a more extended consideration of them is now unnecessary. Suffice it to say that one of the familiar rules they sustain and illustrate is that one may not be an agent to sell for another and a purchaser at the same time, that such a sale is voidable at the election of the principal, and that under this rule, and under the equitable principles to which reference has been made, the sale to Southworth cannot be sustained in a court of chancery. He grasped and held all the powers of the corporation. It could act and contract only through him. He was the agent through whom, and through whom alone, under the law, the corporation and the holders of the minority of its stock could sell its property. He sold it to himself by his use of the powers of the company. If that sale had been fair and open, after full opportunity to all interested to bid, for the highest amount that could be obtained for

the property, it might have been sustained. But it was made for $2,500 to the holder of the majority of the stock, who was one of the members of the board of directors and the president of the company, and to whom one of its stockholders had offered $3,500 for the property only about four months before the sale, and who had written the secretary that, if it was offered for sale, he desired to bid.

The president of the corporation and the members of the board of directors may have acted in good faith, in the sense that they had no intent to inflict injury upon the holders of the minority of the stock. They may have believed that if they procured for the corporation the fair value of the property they discharged their whole duty. In this they were in error. If they could have obtained for the property by an open and honest sale $1,000 more than it was worth, it was their duty to the stockholders of the corporation to do so, and the holder of the majority of the stock could not be permitted to sell it to himself for less. * * *

(a) Manipulation and Sale of Control

ROBOTHAM v. PRUDENTIAL INS. CO. OF AMERICA

Court of Chancery of New Jersey, 1903. 64 N.J.Eq. 673, 53 A. 842.

[On motion for injunction on order to show cause. Heard on bill, affidavits and answering affidavits.]

The bill is filed by the complainants, as stockholders of the Prudential Insurance Company of America, hereinafter termed the "Prudential Company," on behalf of themselves and all other stockholders who may come into the suit, and it sets forth the following case: * * *

The transactions which are subjected to judicial scrutiny in this case may be outlined as follows: The capital stock of the Prudential Company now consists of 40,000 shares, of $50 each, par value. The Prudential directors apparently hold or control a majority of these shares, and thus in the usual way may secure their own election from year to year, and appoint a successor when a vacancy occurs by death. There are at present 91 different stockholders. The president of the Prudential Company in his affidavit states as follows: "A considerable amount of the stock is still held in large blocks by persons who are getting well on in life, so that in the comparatively near future it will inevitably result that said stock will become far more scattered than it is at present. * * *

"It was with these conditions in mind, and with a full realization on the part of the principal stockholders of the insurance company of the vital importance of safe-guarding the interests of over four and one-half million of its policy holders, that the stockholders of the insurance company set about the consideration of some plan that would accomplish this result, conserve the interests of the stockholders as well, and put the assets of the company forever beyond the reach of reckless speculators, who, when the stock has become scattered, might acquire it, even at fancy prices, for the purpose of manipulating its assets, as has been the case in the past in many instances known to all insurance men.

"The plan adopted by the majority of the stockholders of the insurance company was to negotiate a sale to the Fidelity Trust Company of a controlling interest in the shares of the insurance company; that company to double its present capital of $1,500,000, and put out the new stock at $750 per share."

The president's affidavit further sets forth that:

"Concurrently with the plan of the trust company to acquire a controlling interest in the stock of the insurance company, the principal stockholders of the insurance company consider it highly desirable that the insurance company shall acquire a like interest in stock of the trust company, and, at our instance the directors of the trust company have made such contracts with their stockholders that they can tender to the insurance company, at $750 per share, a sufficient number of shares of the new issue to give the insurance company, with their present holding, such control."

There is no dispute about the general nature or any essential details of the scheme for the permanent control of the affairs of the Prudential Company, which its "principal stockholders" have formed, and which its directors have proposed to carry into effect by the exercise of their fiduciary powers.

The Fidelity Company has already entered into a written contract with stockholders of the Prudential Company, by which these stockholders agree to sell enough of their holdings of Prudential stock at $600 for every $100 of par value to give the Fidelity Company one share more than one-half of the total outstanding Prudential capital stock. There is no favoritism or discrimination among the stockholders of the Prudential Company with respect to this contract. Each stockholder is permitted to sell one-half his holdings at the price above stated, and those who sign agree to contribute pro rata enough stock to make up any shortage which may arise by reason of the failure or refusal of any of the Prudential stockholders to sign the agreement. The Fidelity Company, in pursuance of the plan, having doubled its present capital, will give the new stock to subscribers at $750 per share, thus realizing $11,250,000, which will leave the Fidelity Company with a capital of $3,000,000, and a surplus of $13,000,000, and a considerable amount of undivided profits in addition. Of this new stock of the Fidelity Company the Prudential directors propose to take for their company enough of the new shares, at $750 per share, to give their company, with its present holdings, a majority of the capital stock of the Fidelity Company, as the same will stand after the increase has been effected. How much Fidelity stock the Prudential Company now holds is not disclosed, but the president of the Prudential Company states in his affidavit that such holding is large, but less than one-third of the total amount. The acquisition of a majority of the Fidelity stock, as increased, will therefore involve the expenditure by the Prudential Company of over $7,500,000. The book value of the Fidelity stock at present is a little less than $350 per share of $100 each. The result of the above arrangement will be to give the Prudential Company the absolute power to appoint the directors of the Fidelity Company and to give the Fidelity Company the absolute power to appoint the directors of the Prudential Company. Inasmuch as

such an arrangement practically places the corporation whose election of directors comes first within the absolute control of the directors of the other corporation, the president of the Prudential Company announces that—

"The annual meetings of the two companies will be so arranged and other arrangements will be so made that the Prudential Company will forever be the dominant factor, as, of course, it should be."

The Fidelity Company during the past year has paid dividends to its stockholders at the rate of $16 on each $100 of par value. The Prudential Company has uniformly paid annual dividends during recent years at the rate of $10 on each $100 of par value, and has never paid a higher rate of dividends during its existence, and has no present intention to increase the dividends in the future.

Although the above plan has been formed and is approved by the directors of both of these companies, the only complaint in this case is on the part of stockholders of the Prudential Company. The bill prays for discovery against both corporations, and prays that the Prudential Company and its officers and directors may be enjoined, among other things, from voting in favor of the proposed increase of the capital stock of the Fidelity Company, and from subscribing for or purchasing any shares of such increased capital, and that the Fidelity Company may be enjoined from receiving the vote of the Prudential Company in favor of said increase of stock. The defendants consist of the two corporations and the directors of the Prudential Company.

STEVENSON, V. C. (after stating the facts). The basis of any preliminary injunction in this case must be found in some legal or equitable right of the complainants, as stockholders of the Prudential Insurance Company, to prevent their trustees, the Prudential directors, from injuring them by a violation of fiduciary duty. The interesting scheme above set forth for the exercise of all the powers of these two great corporations by a perpetual and self-perpetuating syndicate has received the approbation of the boards of directors of both companies. But no stockholder of the Fidelity Company is before this court with any complaint. In applying legal tests to the scheme as a whole, and to its various parts, as distinct corporate acts, we are confined to the consideration of the rights and remedies of these two dissenting stockholders of the Prudential Company. * * *

(3) It is impossible, within the reasonable limits of this opinion, to discuss the question of the disqualification of these directors by reason of their self-interest in its application to their scheme as a whole, and to each of its constituent parts.

The most serious question of this kind, relating to the separate parts of the scheme, is raised by the fact that the Prudential directors are proposing to add eight or ten million dollars to the capital of the Fidelity Company by a subscription for new stock, although one-half of the entire Prudential board are directors of the Fidelity Company, and consequently stockholders of that company. I prefer to avoid the discussion of this question of disqualification in its relation to any of the details of this scheme as independent transactions. Upon the argument, as I understood the statements of counsel for complainants, they admitted most amply that, as a matter of fact, these Prudential di-

rectors are not actuated by a selfish desire to sell a portion of their holdings of Prudential stock to the Fidelity Company in order to receive therefor a sum of money coming from funds in a large part contributed by the Prudential Company under their control and direction; nor are they in fact supplying to the Fidelity Company this large increase of capital from the funds of the Prudential Company in order to benefit the former company at the expense of the latter.

But the question of the capacity or incapacity of this particular board of Prudential directors to adjudicate upon the advisability of this proposed scheme as a whole is a very different matter, and one which alone, in my opinion, would control the decision of this motion. This is the last question which I shall undertake to discuss.

How far self-interest of a director in opposition to the interest of his corporation disqualifies him from acting as a director, or exposes corporate action to injunction at the arbitrary election of a dissenting stockholder, or exposes such action to review by the courts at the instance of such stockholder, are matters about which the authorities are not entirely in accord. 2 Cook, Corp. (4th Ed.) § 658; 3 Thomp. Corp. §§ 4059, 4063, 5650; 7 Thomp. Corp. § 8502; Stewart v. Railroad Co., 38 N.J.L. 505, 522; Metropolitan Tel. & Tel. Co. v. Domestic Tel. & Tel. Co., 44 N.J.Eq. 568, 573, 14 A. 907.

On the one hand, it may be urged with great force that a minority stockholder has a right to repose upon impartial, unbiased action on the part of the directors who are his trustees, and that he ought not to be obliged, where directors have been acting on both sides of a transaction, or are proposing so to act, to come into court with proofs of actual injury to himself or to the corporation. On the other hand, theoretical rules have to give way to the practical necessities of business. Business eventually is not extended, and great departments of human activity are not developed, by means which are fraudulent. The use of such means in the end is suicidal. In these days the relations of corporations to each other are exceedingly complex. Common directors abound, and common directors are better than dummies. Whether a transaction between two corporations has been accomplished or remains executory, I incline strongly to believe that the safe rule in most cases, in the end, will be found to be that the presence of a director or directors on both sides of the transaction under investigation does not give the dissenting stockholder an arbitrary right to an injunction, but may give him a most ample right to subject the transaction to the scrutiny of the court, and may cast upon the corporations or directors concerned the burden of disclosing and justifying the transaction.

To give the dissenting stockholder the arbitrary right to an injunction in this class of cases often will put a deadly weapon in the hands of the blackmailer and the corporation "striker." Such a rule tends to drive the actual wrongdoers to cover,—to induce them to seek concealment while the corporate action is accomplished through apparently impartial directors, who are in fact only agents or "dummies." In several recent cases before this court where the existence of common directors was relied on for injunctive relief, these common directors while the motion was pending were made to disappear, and apparently impartial directors took their place, who proceeded solemnly to approve

of the action of the old boards which the injunction was designed to restrain.

The fiction of corporate existence goes down in many cases before a charge of fraud, but I incline to think that this fiction in most cases belonging to the class under consideration should be rigidly maintained to defeat a mere arbitrary demand on the part of a stockholder that a corporate transaction should be enjoined, even though all the impartial directors of the corporation and nine-tenths of the stockholders come into court with a demonstration that the transaction was advantageous in all respects to their corporation, and that an injunction upon it would cause great loss.

But whether in this case dissenting stockholders can arbitrarily prevent corporate action on the ground of the presence of directors or a majority of directors having a hostile interest, I do not intend to consider. I propose to apply, not to the details of this scheme but to the scheme as a whole, what certainly is a safe rule, viz., that where all the directors of a corporation have a direct, valuable interest in the action which they propose to take, in which interest their stockholders do not participate, these stockholders may compel them, before they will be allowed to carry out their scheme, to prove before the court that it is advantageous to the corporation.

It seems to me that the disqualification of these 14 directors to adjudicate finally that their scheme for exchange of control is advantageous to the Prudential Company is clear and absolute.

That the proposed scheme, if carried into effect, will directly and necessarily benefit these 14 directors, and secure to them great emoluments and great influence and power, seems to be a fact beyond dispute. The salaries and other advantages controlled by the directors of an insurance company holding to-day nearly $60,000,000 of assets, and contemplating in the near future the possession of a hundred or even two hundred million dollars of assets, constitute a personal prize of very great magnitude.

It is not an answer to this proposition to say that these directors already hold this prize in their possession. They do not hold it in perpetuity for themselves and those successors whom they will personally select from time to time as death makes vacancies in their board. The effect of the scheme is to prevent them and their chosen successors from losing the prize after they have ceased to own beneficially the majority interest in the stock which now keeps the prize in their possession.

These 14 directors have never made an independent and unselfish adjudication that this scheme will be beneficial to the Prudential Company. They do not exclude themselves from the charmed circle which their scheme contemplates. They propose to sit therein to the exclusion of the other stockholders. That this is their plan is evident, and is not denied. The Prudential directors are to "dominate," and, if any change in the membership of the Prudential board were contemplated before the scheme is to go into effect, the defendants ought to have proved, and could easily have proved, such fact. If these directors had merely feared that in the future a combination of a majority of stockholders owning eight or ten million dollars worth of Prudential stock

might commit a "depredation" not merely upon the salaries and perquisites of the managers of the company, but upon the assets of the company which belong to its policy holders and stockholders, they could easily have arranged their scheme so that in effecting its adoption they would be free from any disqualification arising from selfish interests. If, for instance, they had planned to select 14 men of high character and standing in the business world, and then to see that each of these men was duly qualified with at least one share of Prudential stock to act as a director, and then to make these 14 independent men the personal syndicate for perpetual control, while they themselves unselfishly retired forever from the scene of their labors and the possession of their emoluments as managers, they would then have presented a scheme which would not be open to the particular objection now under consideration. They have not done this, nor have they apparently considered such a possible situation,—much less, given it their approval as directors.

Applying to the situation the very moderate and safe rule above mentioned, the result is that the favorable judgment of these 14 directors, when challenged by a dissenting stockholder, is to be practically excluded from consideration, and the burden is placed upon these directors of making full disclosure of their scheme to the court, and of presenting clear and satisfactory proof that it will in fact be advantageous to the Prudential Company. In the absence of such proof, the scheme cannot receive the commendation of a court of equity; and, as it has not received the commendation of an impartial board of directors, it must be interdicted.

Could a single equity judge, or even a bench of such judges, unaided by experience in the management of insurance companies, and unaided by the favorable judgment of a board of insurance managers and experts qualified to express an impartial opinion, find in the evidence so far produced in this case safe grounds for the affirmative conclusion that this startling novelty in corporation law and corporation business is a safe and prudent thing for the Prudential Insurance Company to adopt and establish? I think not, and on this ground alone, in my opinion, an injunction should go.

I do not wish to be misunderstood upon this point. The situation in which this court is asked to give its approval to this novel scheme must be kept distinctly in view. A court of equity, if it had the power to review the honest acts of the Prudential directors within the scope of their powers, which it has not, might well in any case repose upon the deliberate judgment of these directors, sanctioning any scheme as beneficial to their company, in view of their commanding position as expert insurance managers, and their conceded freedom from any intention to violate their fiduciary duty. But the difficulty is that under the rule above defined, and applied to this situation, the official judgment of these directors cannot be resorted to in order to aid the judgment of the court. Their testimony as individuals, of course, can be accepted for what it may be worth. It is from all the testimony in the cause on both sides that this court is asked to find affirmatively that the establishment and maintenance of this self-perpetuating syndicate for the perpetual control of the Prudential Insurance Company will be advantage-

ous at least to the stockholders of that company, including the complainants.

The evidence produced on this motion, bearing upon the sharp question whether the establishment of this novel and ingenious scheme for the control of a great insurance company with $60,000,000 of assets,—a scheme which has not been intentionally created by the insurance statutes of the state,—would be wise, safe, and advantageous to the Prudential Insurance Company, is extremely meager. This evidence, in my opinion, not only fails to justify a judgment of this court in approval of the scheme, but raises the gravest apprehensions that the scheme, if carried out, would be a continuous menace to the policy holders and the stockholders of the Prudential Company, which would grow more and more portentous as the years go by, and these faithful and experienced men, one by one, vacate their seats of power and give place to other men who are now unknown; that after all or almost all of the present board of directors have passed away, and the majority of the board has undergone several changes, this scheme might even destroy this great insurance company, which these present directors have created, and which now stands as a monument to their integrity, wisdom, and skill.

My conclusion upon the whole case presented on this motion is that the Prudential Company and its directors should be enjoined from subscribing for the new issue of Fidelity stock as a specific act, which, without reference to its connection with the scheme for exchange of control, is unauthorized by the laws which define the manner in which the funds of the Prudential Company are to be invested. The Prudential directors should also be enjoined from doing any act in the exercise of their power as directors with intent or with the effect to carry out the scheme of lodging perpetual control of the two companies in the directors of either or both of the companies. The injunction will not interfere with the power of these directors to cause the vote of the Prudential Company upon its stock in the Fidelity Company to be cast in favor of increasing the capital stock of the latter company, either at the present time, or at any time hereafter when, independently of the scheme which this court has condemned, they may impartially adjudge such increase to be beneficial to the Prudential Company as a stockholder of the Fidelity Company, provided the effect of such increase, as a separate act, or in connection with other acts, facts, or conditions, will not result in, or be the means of, creating the combination of conditions under which the above-mentioned scheme may go into effect. In dealing with any and all separate lawful acts within their power and within the power of their corporation, these directors must see to it that they do not, by such acts as they may separately consider advantageous to their corporation, establish the condition of corporate control which this court has found to be injurious to the complainants and the other stockholders of the Prudential Company.

INSURANSHARES CORPORATION OF DELAWARE v. NORTHERN FISCAL CORPORATION, Limited, et al.

District Court of the United States, D. Pennsylvania, 1940. 35 F.Supp. 22.

In Equity. Suit by the Insuranshares Corporation of Delaware against the Northern Fiscal Corporation, Limited, and others, to recover damages incurred by the plaintiff as the result of the sale of control of plaintiff corporation to a group who deprived it of most of its assets.

Judgment for plaintiff.

KIRKPATRICK, DISTRICT JUDGE. This is a suit brought by a corporation against its former officers, directors, certain of its former stockholders, and others, to recover damages incurred by the corporation as a result of the sale of its control to a group who proceeded to rob it of most of its assets. The plaintiff is an investment trust, specializing in shares of small life insurance companies.

A number of the defendants have not been served with process. Those before the Court are three Philadelphia banks, formerly stockholders, and William W. Hepburn, their representative on the board of directors.

Certain of the defendants were, prior to December 21, 1937, the owners of 75,933 of the corporation's total outstanding 284,032 shares. These defendants will be referred to collectively as the management group. This group consisted of the Philadelphia banks, with 23,106 shares, and their agent, Hepburn; Blair (the president of the corporation) and his associates, Simmons, Moore and Burnell (all former directors), and Ogden, with 24,111 shares; the Continental Bank, with 26,569 shares (subsequently taken over by Fahnestock & Co.); and Logan, receiver of the Seaboard Continental Corporation, with 6,647 shares. The board of directors of the corporation was composed entirely of this management group or their nominees. The defendants, Robb, Morris and Solomont, who bought control and who, with their satellites Quint, Stanton, Tracy and Hansell, looted the corporation, constitute the Boston group.

There is little dispute about the main facts. On December 21, 1937, the management group transferred the control of the corporation to the Boston group, none of whom had ever had any interest of any kind in it. With the control, as that term is here used, went plenary power under the by-laws to sell, exchange or transfer all of the securities in the corporation's portfolio, as well as access to and physical possession of them. In this case, acquisition of control was the indispensible first step of a scheme, planned by Robb, Morris and Solomont with the connivance of Paine, Webber & Co., brokers, the purpose of which was to strip the corporation of its valuable assets, leaving its mere shell to the remaining stockholders. The project was carried out with thoroughness and dispatch, but its subsequent steps and its disastrous results to the corporation are not in dispute and need not be detailed here.

The actual transfer was made in accordance with a program to which the Philadelphia group assented and the steps of which they followed. Immediate and complete passing of control was ensured by the succes-

sive resignation of the old directors, each resignation being followed by the election of a new member of the board, on the nomination of the Boston group. At the same time, the management group sold and delivered their stock to the Boston group.

The defendants have insisted throughout the case that the transfer of December 21, 1937, was simply a sale of stock, the passing of control being merely a normal concomitant, and most of their argument was based upon this premise. This view, however, I think is fundamentally wrong. If the whole record be read, I do not see how the transaction can be considered as anything other than a sale of control, to which the stock sale was requisite, but nevertheless a secondary matter. The fact is that the Boston group were interested in only one thing, namely, to have a free hand with the corporation's portfolio for a few weeks, and all they needed for that purpose was to be able to name and control the officers and directors. Perhaps there would have had to have been some modifications in their procedure, but practically everything they did could have been done without their owning more than directors' qualifying shares. As a matter of fact, they bought only about 27% of the outstanding issue, and, throughout their operations, they were never anything but minority stockholders. Of course, I am not suggesting that the purchase of the stock was not a sine qua non for the success of their plans. It assured them, temporarily, of noninterference from stockholders, since the majority, who had bought for investment, could be counted on to remain inert. It would have been absurd to expect such acquiescence from the management group, had they retained any stock interest, and equally absurd to expect them to part with control, without at the same time getting out of their investment in the corporation. Hence the necessity for the purchase of the stock. The buyers were primarily interested in getting control of the corporation together with such stock ownership as would make that control secure and untrammelled, and the sellers were primarily interested in getting as much money as possible for what they had to sell—both the control and their interest in the assets.

The price is strongly indicative of the true nature of the transaction. The sellers obtained $3.60 a share at a time when the price of the stock in the over-the-counter market was $1 to $1.25, and when the book value was $2.25—a figure substantially higher than could have been realized on actual liquidation. The history of the bitter dispute between the Continental Bank and the rest of the management group, beginning in June of 1937, shows that the latter, although they had no desire (and most of them no special capacity) to operate the corporation, were not content to liquidate and take the cash and actual market value of the securities represented by their shares, but were determined to obtain the additional premium which a sale, carrying with it control of the corporation, would bring. Confirmation is given by the fact that from June 1937 the principal activities of the managers consisted of negotiations for the sale of their stock. The facts that the first of the potential purchasers turned out to be irresponsible and that they had only the vaguest notion as to the identity of the second (who withdrew at the last minute) were apparently no discouragement.

Assuming then, as I think we must, that what is involved here is primarily a sale of control, it is an incontrovertable fact that the act of the management group in selling control to the Boston group was the thing which made possible the latter's criminal operations.

Those who control a corporation, either through majority stock ownership, ownership of large blocks of stock less than a majority, officeholding, management contracts, or otherwise, owe some duty to the corporation in respect of the transfer of the control to outsiders. The law has long ago reached the point where it is recognized that such persons may not be wholly oblivious of the interests of everyone but themselves, even in the act of parting with control, and that, under certain circumstances, they may be held liable for whatever injury to the corporation made possible by the transfer. Without attempting any general definition, and stating the duty in minimum terms as applicable to the facts of this case, it may be said that the owners of control are under a duty not to transfer it to outsiders if the circumstances surrounding the proposed transfer are such as to awaken suspicion and put a prudent man on his guard—unless a reasonably adequate investigation discloses such facts as would convince a reasonable person that no fraud is intended or likely to result. Thus, whatever the extent of the primary duty may be, circumstances may be sufficient to call into being the duty of active vigilence and inquiry. If, after such investigation, the sellers are deceived by false representations, there might not be liability, but if the circumstances put the seller on notice and if no adequate investigation is made and harm follows, then liability also follows.

From a careful reading of the voluminous evidence in this case, I have become convinced that facts and circumstances leading up to this sale, as known to Hepburn, the agent of the banks, and as largely relayed by him to Hardt, his immediate principal, were sufficient to indicate to any reasonable man in his position that the Boston group were acquiring the control of the corporation by improper means and for an improper purpose.

I have just referred to acquisition by improper means. What happened was that the buyers had arranged with Paine, Webber & Co. that the latter would advance the price of the purchase (some $310,000) on an unsecured loan, and that, immediately after they had obtained control, the portfolio, or as much of it as was necessary, would be pledged with Paine, Webber & Co. as collateral, sold by them from time to time, the proceeds applied to liquidating the note, and the balance turned over. Comment as to the legality and ethics of this procedure is unnecessary, but the point is that if Hepburn had good reason to suspect that the purchase was to be financed in toto with the corporation's assets, it would be fair warning of the fraudulent nature of the whole thing. So, in considering whether the circumstances of this sale called for a real investigation, one matter of importance is what was known or to be inferred as to the manner in which the purchase was to be financed.

On turning to the record, one learns, with some surprise, that this same corporation had been systematically looted some five years before by a different group who bought control, using exactly the same means

of financing the deal, and who stole the assets of the corporation in much the same general way. This episode was known in all of its details to Hepburn. In fact, the banks had become stockholders, unwillingly, as a result of the wreckage caused by it. In June, 1937, the persons responsible for the loss had settled their liability from some $650,000, of which perhaps half had come into the treasury of the corporation. This, of course, is not proof that a new group would do the same thing, but it certainly was a vivid reminder of the special dangers to which these small and helpless investment trusts were constantly exposed.

In the second place, by December, if not before, Hepburn knew perfectly well that in arranging for the sale of the banks' interests he had, in Blair, a collaborator who was entirely willing that the corporation's assets should be used to finance the deal. Even accepting at its face value Hepburn's testimony as to his own limited role in the negotiations, it is a fact that he was in frequent consultation with Blair, the corporation's president and the most active figure in promoting the various attempts to sell. Hepburn, Blair and Simmons constituted the executive committee of the board. During the entire summer of 1937 Blair had been busily engaged in conducting negotiations for the sale of the interest of the management group to another financially irresponsible syndicate, headed by a promoter named Johnston. This sale aborted but, previous to that and for the purpose of getting rid of the determined opposition of the Continental Bank with its 26,569 shares, it had been arranged that Johnston should buy out the Continental Bank and that he should obtain the money on a loan from Fahnestock & Co. upon a promise that he would put up securities from the corporation's portfolio as collateral security after he obtained control of the corporation. This was exactly like the Paine, Webber financing of the Boston group later on in December. The sale to Johnston failed to go through, and Fahnestock, who had advanced the money to the Continental Bank and acquired its shares for the account of Johnston, was thus left holding the bag, with plenty of recrimination against Blair, who, they said, had arranged the whole thing and who, no doubt, had. It is undisputed that Hepburn got the whole story from Fahnestock & Co.'s attorney not later than October 15, and though he testified that he "never got to the bottom of the matter" and though Blair denied his part in the transaction, it is impossible that Hepburn could have been under any misapprehension as to what had occurred or as to the fact that Blair had actively participated in it.

Thirdly, Hepburn had fair notice that, whatever the plans of the purchasers might be, one part of their program was to have a large part of the corporation's assets converted into cash and available in that form the minute they took over control. It appears that the corporation had invested some $400,000 of its assets (including the cash received from the settlement of the suit against its earlier looters) in certificates of New England Fund—another investment trust of a somewhat different type. The terms of this trust provided that holders of these certificates could obtain either the cash value of the purchase or the underlying securities which they represented upon five days notice to the New England Fund. A special meeting of the board of directors of Insuran-

shares was called for December 16, five days before the date fixed for closing. The directors were advised that the purchasers wanted a resolution passed apparently authorizing Solomont without any restrictions to get the money from the New England Fund on December 21—the day to which the closing had been postponed (the five days' notice had already been given by Blair on the morning of the 16th). They balked at this, but finally did pass a resolution directing the New England Fund to transfer the certificates to Solomont upon his being elected and qualified as treasurer of Insuranshares. As a matter of fact, immediately after the consummation of the deal, Solomont flew to Boston with the certificates and succeeded in turning them into cash.

Fourthly, the inflated price paid by the Boston group for the banks' shares has already been considered as evidence that they were primarily interested in buying control, but I do not think it can be disregarded as being also some indication that they had an improper purpose in view. Why were the purchasers willing to pay so much for control? I should think this question might well have occurred to one who was selling it. No doubt if this corporation had been an industrial, mining, or commercial enterprise, whose physical assets and business might have potentialities which a purchaser might believe he could develop if given control, the price would not mean very much. It was, however, merely an investment company, and the ultimate assets—what was really being sold—were nothing but the ready equivalent of cash in marketable securities.

Fifthly, Hepburn and the banks were specifically warned at least twice of the danger of carrying out the deal with parties about whom they knew so little. Simmons, the corporation's lawyer, discussed the matter at length at a conference at which Hepburn was present, and embodied his thought in a memorandum, which Hepburn may or may not have received and brought to Hardt's attention. He "pointed out the possible consequences to you individually should Insuranshares suffer a loss through the operations of a group of men to whom you made possible the acquisition of the stock of the company." Johnston followed this on the same day by writing a letter to Hardt. Whether or not Hardt actually ever saw this letter, Hepburn was familiar with its subject matter and discussed it with Hardt.

There were other things of less importance, and they must all be read in the setting of the transaction, beginning as far back as June or July, 1937. There was simply too much of the sort of thing described for this transaction to pass as a perfectly normal stock sale. I think that the circumstances were such as to indicate to any reasonable person to whom Hepburn's knowledge of what was going on could be imputed, that there was more than a possibility of fraud and consequent injury to the corporation in the sale. That being so, there plainly was a duty upon the sellers to make a genuine effort to obtain and verify such information as they reasonably could get about the means by which the purchase was to be financed and the character, aims and responsibility of the purchasers, or, in the absence of adequate information, to refrain from making the sale.

The Philadelphia banks made no adequate investigation. One or two desultory inquiries were made to who the purchasers were. Naturally,

with a sale of this magnitude in the offing, anyone will make sufficient inquiry to satisfy himself that it is worth the trouble of further negotiations and that, if terms can be arranged, he is likely to get his money. That, it seems to me, is about the sum of what the banks did; and the sum of the affirmative information they obtained was that the purchasers were three Boston attorneys, one of whom (Solomont) had been local attorney for the Paine, Webber & Co., and that Morris was a reputable attorney. Of course, they had Blair's recommendation—a matter of somewhat equivocal force. In addition, Maloney, a friend of Hardt's and the president of the Philadelphia Life Insurance Company, reported to Hardt that he could discover nothing about Morris which would make him unsuitable as a director for the Philadelphia Life Insurance Company. Jackson and Curtis, brokers, reported to Hardt that "they knew of them (the buyers); they had no knowledge of their financial responsibility and knew nothing to their detriment." Surely, no one would suggest that the banks would have accepted this as satisfactory if they had been retaining any substantial stake in the corporation.

Specifically, the banks, with all their credit facilities made absolutely no investigation of the financial standing and resources of the purchasers and at no time received any information to indicate to them that the purchasers had any money whatever. They knew that money to pay for the stock would be somehow forthcoming through Paine, Webber. In spite of their knowledge of the methods in which at least two previous fraudulent purchases of investment trusts had been financed by brokerage houses with the trusts' portfolios, they made no effort to find out what was to be behind Paine, Webber's certified check. As to the first of these points there can be no question that any sort of investigation would have revealed that the purchasers were not remotely able to finance a $300,000 deal from their own resources. As to the second, the performance of Paine, Webber & Co. throughout was so naive as to make it quite likely that, if any inquiry had been made, the whole method of financing would have been cheerfully disclosed. At any rate, it is not necessary to speculate as to what would have been the result if the duty of reasonable investigation had been performed. If, after inquiry, facts had been refused or misrepresented, a different question would be presented. The fact is that no genuine investigation was made.

I realize that it is expecting a great deal of businessmen, or anyone else, for that matter, to say that they should make searching inquiries which might result in disclosing facts which would upset an advantageous and apparently perfectly legal piece of business. And, by the same token, it takes no stretch of the imagination to conclude that Hepburn was not making any great effort to inform himself about the means which these three Boston lawyers were going to adopt to enable them to buy an investment trust for $300,000.

It is not proposed to make an analysis of the many authorities cited by the parties in this case. The complexities of cases involving liability for transfer of corporate management are so great and the facts so diverse that excerpts from court opinions are of comparatively little value. The facts of each decision must be known to fully appreciate the

rule which it lays down. Cases more or less in point are: Field v. Western Life Indemnity Co., C.C., 166 F. 607; Id., 7 Cir., 179 F. 673; Oil Shares, Inc. v. Kahn, 3 Cir., 94 F.2d 751, reversed on other grounds, Oil Shares v. Commercial Trust Co., 304 U.S. 551, 58 S.Ct. 1059, 82 L.Ed. 1522; and Bosworth v. Allen, 168 N.Y. 157, 61 N.E. 163, 55 L.R.A. 751, 85 Am.St.Rep. 667.

The defendants do not deny the force of the authorities but take the position that in the present case, the banks at least owed absolutely no duty of any kind to the plaintiff corporation or its remaining stockholders. The point at which they draw the line is that the duty does not come into existence as to mere stockholders "except when those stockholders do not content themselves with the ordinary functions of stockholders, but take upon themselves the powers and prerogatives of directors." As a corollary to this proposition, the defendants contend that in cases where a duty does exist it is only in respect of direct dealings with the corporate property, and can never attach to dealings in its stock.

The fundamental difficulty with the defendants' position is that it fails to recognize that this case involves more than a question of liability—even that of majority stockholders, which these defendants were not—in respect of the sale of corporate stock. What is involved here, as has been pointed out, is a sale of control by a minority, but controlling, interest. The duties and liabilities in such case may be more than I have assumed them to be for the purposes of this case, but they are certainly not less. I have stated them as narrowly as possible, and I think that as so stated they are well grounded in the law.

Several minor and more or less technical questions raised by the defendants remain to be considered.

The bill in equity filed in this case might, under the old practice, have been open to the objection that it pleads two distinct causes of action, first, conspiracy to defraud, and, second, negligence. I have held that the owners of control of a corporation occupy a fiduciary relationship to the corporation and its stockholders in respect of the transfer of control and that they owe a duty of due care—a duty in which these defendants failed, with consequent loss to the corporation. This cause of action is sufficiently pleaded, and the charge of knowingly participating in a fraudulent conspiracy may be dismissed as surplusage. It was not established by the evidence, but the testimony directed to it has a bearing upon the alternative charge. The Federal Rules of Civil Procedure 28 U.S.C.A. following section 723c, are fully applicable, and Rule 8(e) (2) provides that: "A party may set forth two or more statements of a claim * * * alternately or hypothetically, either in one count * * * or in separate counts * * *."

It appears that Paine, Webber & Co. have settled their liability to the corporation and that an instrument was delivered to them which, the defendants contend, operates as a general release and extinguishes the plaintiff's right of action against the remaining defendants. The instrument in question in words: (1) released Paine, Webber & Co.; (2) expressly reserved the plaintiff's rights against all other parties, including specifically Hepburn and the Philadelphia banks; (3) declared it to be the intent of the parties thereto that it should be con-

strued and given effect as and only as a covenant not to sue; (4) expressed the plaintiff's covenant not to sue Paine, Webber & Co.; (5) declared that such covenant was not to affect or prejudice plaintiff's expressly reserved rights against any other parties.

The defendant invokes what has been called "one of those harsh, although strictly logical common-law, rules which has had to make way for the modern tendency to substitute justice for technicality." Walsh v. New York C., etc., R. Co., 204 N.Y. 58, 63, 97 N.E. 408, 410, 37 L.R.A.,N.S., 1137. Although the instrument at its beginning uses technical words of release, if read as a whole in the light of its plainly expressed and dominant intention to reserve the plaintiff's rights against all other parties, I think it must be construed as a covenant not to sue—particularly as the parties provide, "it being the intent of the parties that this instrument be construed and given effect as and only as a covenant by the party of the first part not to sue the parties of the second part." Even if these words were not present, I am of the opinion that a release coupled with an express reservation of the rights of the releasor against another joint tort feasors would not destroy those rights in any of the three possible jurisdictions (New York, New Jersey or Delaware) the law of which might apply. However, it is the law everywhere that a covenant not to sue does not affect the covenantor's rights against other joint tort feasors, and I think this instrument is plainly to be so construed.

The judgment to be entered here will be for the plaintiff generally. Further proceedings for the purpose of assessing damages and including the amount in the judgment may be taken unless an agreement can be reached upon that point.

LEVY et al. v. AMERICAN BEVERAGE CORPORATION et al.

Supreme Court of New York, Appellate Division, First Department, 1942.
265 App.Div. 208, 38 N.Y.S.2d 517.

Action by Samuel N. Levy and others against the American Beverage Corporation, Edwin C. McCullough, the McCullough Corporation, the Manufacturers Trust Company, as executor under the will of Benjamin B. Avery, deceased, Theodore W. Stemmler, the Ronaldo Realty Corporation, and others for the amount of financial losses sustained by defendant beverage corporation and an alleged profit illicitly made by defendants McCullough and McCullough Corporation on sale of their stock in defendant beverage corporation. From an interlocutory judgment on a decision directing an accounting before a referee, except so far as such judgment dismisses the complaint against defendants executor, Stemmler and realty corporation, defendants McCullough and McCullough Corporation appeal, and from so much of the judgment as provides that the costs of stenographic minutes of the reference and the referee's fees be paid by defendant beverage corporation in the first instance and added to any judgment in its favor, such corporation appeals.

Judgment, so far as appealed from, reversed, and complaint dismissed on the merits.

CALLAHAN, JUSTICE. The defendants-appellants, former owners of a majority of the voting stock of American Beverage Corporation, have been held liable for financial losses sustained by that corporation. All of these losses occurred after appellants ceased their connection with the company, and were due to the misconduct or mismanagement of persons to whom said appellants sold their corporate stock.

In addition, appellants have been compelled to pay over to American Beverage Corporation an alleged profit in the sum of $169,000, which it has been found was illicitly made by them on the sale of their stock, although in fact they sold it for less than they paid for it.

The theory on which this drastic judgment rests is that appellants held controlling stock interest in the American Beverage Corporation and that by reason of such control they owed the duty of fiduciaries to the corporation, and to the minority stockholders thereof; that, as such fiduciaries, they were bound to make proper investigation of the moral and financial responsibility of the purchasers of the stock, as well as to the source of the funds used to acquire the stock. Breach of these duties was found here, based on the holding of the trial court that circumstances had occurred in connection with the sale conveying knowledge or notice to the sellers that the purchasers were morally and financially irresponsible; that they planned to use the credit of American Beverage Corporation to secure the funds to pay for the stock; and that they intended to mismanage the company, and to convert its assets to their own use.

We find that the evidence adduced upon the trial did not warrant the inferences drawn by the trial court from the facts established, and that an erroneous rule of law was applied in fixing the duty and liability of the appellants.

Plaintiffs, who were minority stockholders suing in a representative capacity, attempted to prove their contentions largely from testimony extracted from defendants and other persons connected with the sale of the stock. There is no doubt from the proof that sale of stock control of American Beverage Corporation by appellants resulted disastrously to American Beverage Corporation. Nor is there any doubt that the purchasers used fraudulent methods which, in effect, used the funds of American Beverage Corporation to reimburse themselves for the purchase price of the stock acquired. The real issue here was whether appellants by reason of any dereliction of duty on their part are to be charged with liability for the misconduct of the purchasers.

A statement of the essential facts is necessary in order to point out the errors which require reversal.

Appellant, Edwin C. McCullough, was president and director of American Beverage Corporation, placed there by a board of directors selected by him through control of fifty-three per centum (53%) of the voting stock of the corporation. This controlling stock was owned by the McCullough Corporation, co-defendant, the stock of which, in turn, was owned by members of the family of Edwin C. McCullough. McCullough was president, and in active charge of the affairs of both corporations. He was entrusted with the voting rights of the stock, and took entire charge of the sale of said stock. Under the circumstances

we shall treat the liability of both appellants as the same, without attempting to make any nice distinctions as to their obligations.

Edwin C. McCullough had been the directing spirit of American Beverage Corporation for several years prior to the occurrences herein. Under his guidance the corporation which dealt in soft drinks, and later in wines and liquors, had been built up into a sound and prosperous concern. He had selected as fellow directors men of large business interests. One of them was Theodore W. Stemmler, an investment banker. Another was Benjamin B. Avery, who was attorney for and secretary of the corporation. The appellants owned approximately 72,000 shares of the common stock, which had a par value of one dollar. As heretofore stated, the 72,000 shares represented fifty-three per centum (53%) of the voting stock. This stock had cost the McCullough Corporation upwards of $400,000, or about $5.60 a share. The stock was listed on the New York Curb Exchange, but was inactive. At the time of the sale involved it had a book value of about $4.31 a share, and the books were kept on a very conservative basis. The common stock however, sold on the exchange at very much less than the book, or liquidating value, and at times as low as one and one-eighth ($1.12½) a share.

American Beverage Corporation occupied a plant in New York City which was owned by a corporation controlled by the McCullough family. A very favorable long term lease was held by the landlord.

In June or July, 1938, through Stemmler, a proposal was made by defendant, Irving Feinberg, to merge a company, known as Prendergast-Davies Co., Ltd., controlled by him, which was in the wine and liquor business, with American Beverage Corporation. Edwin C. McCullough rejected this proposition, but offered to buy the assets of Prendergast-Davies Co., Ltd., if their existence and value as stated on a balance sheet shown to him could be verified. That balance sheet showed Prendergast-Davies Co., Ltd., had net assets of $120,000. The deal fell through when Feinberg insisted on receiving a contract of employment with American Beverage Corporation. McCullough admitted that he knew that Prendergast-Davies Co., Ltd., had at one time been controlled by a man connected with the illegal sale of liquor, and that Feinberg had bought control from that man.

In October, or November, 1938, again through Stemmler, one H. Vaughan Clark, a Philadelphia banker, apparently of good repute, proposed merging American Beverage Corporation with a distillery controlled by him. Clark told a rather convincing tale of his intention to merge a number of beverage and liquor companies into a larger company. McCullough would have nothing to do with this merger, but offered to sell his 72,000 shares of stock for cash. After considerable negotiations, an option was given by McCullough to Clark, in which Stemmler was nominated as the buyer, whereby the 72,000 shares were to be sold for $250,000, or approximately $3.50 a share. This option expired on December 16, 1938. On December 15, Clark advised McCullough that he could not close the deal, and desired a further option of thirty days. When Clark agreed to pay $10,000 for this further option, McCullough consented. Thereupon a lawyer, George J. Mintzer, appeared on the scene, and it was made known that Prendergast-Davies

Co., Ltd., and Feinberg were interested in the deal for acquiring the stock. The $10,000 was produced by Mintzer, and the second option ran to Feinberg. Statements continued to be made, however, as to the larger merger. In fact it was stated that Feinberg was to be employed as selling agent of the new company in New York.

This second option was to expire on January 14, 1939. The regular annual meeting of stockholders of American Beverage Corporation was set for January 17, 1939. On January 7, 1939, in accordance with a custom of long standing, requests for proxies were sent out to minority stockholders, which, in substance, stated that the old board of directors would be continued. The second option was exercised on January 14, 1939, the sale was consummated, and a proxy given to Feinberg to vote the 72,000 shares being sold by the McCulloughs. The propriety of notifying the minority stockholders of the change in control was discussed among the McCulloughs, Avery, and others. A letter of notification was prepared, but never sent, Avery advising that insufficient time existed for these letters to reach stockholders so as to be of any avail before the meeting. However, an account of the change in control of American Beverage Corporation was published in the newspapers of January 18, 1939. A new board of directors nominated by Feinberg was elected at the meeting of January 17. That board included Clark. Stemmler, though not elected in January, was re-elected to the Board in March, 1939, in place of Clark. The proxies received from minority stockholders were voted for the old board in accordance with the statements contained in the letter soliciting them. No proof was adduced to show that McCullough knew, even at that time, that the larger merger which had been discussed was not to go through. From the 14th day of January, 1939, McCullough was actually out of control of American Beverage Corporation, although he received his salary for the balance of the month of January. On January 18, under Feinberg's direction, an agreement was entered into whereby Prendergast-Davies Co., Ltd., sold its assets (other than its 72,000 shares of American Beverage Corporation stock) to American Beverage Corporation, and, in return, American Beverage Corporation assumed the debts and liabilities of Prendergast-Davies Co., Ltd. Almost immediately after this agreement was signed, drafts totaling $115,000 were drawn at Feinberg's direction on the bank account of American Beverage Corporation to pay merchandise creditors of Prendergast-Davies Co., Ltd. McCullough happened to be in the office at the time these drafts were drawn, and the treasurer, who had been asked to sign the checks told McCullough of the transaction. His response was to the effect that the treasurer should be careful that he was not doing anything criminal. As all transactions after January 14th occurred under Feinberg's directions, and at a time when McCullough was no longer in control, it would be improper to ascribe liability to appellants for anything occurring after that date, unless they were occasioned by some misconduct occurring before the date of sale. Many things occurred after Feinberg obtained control which contributed to the financial difficulties of American Beverage Corporation. Among these were the cutting off of credit by banks from which American Beverage Corporation had previously obtained commercial

loans, the cancellation of the basic liquor permit held by American Beverage Corporation, market conditions in the sale of beverages, and financial difficulties of subsidiary companies controlled by Feinberg, the stock of which companies had been used by Feinberg in connection with the completion of the merger.

The trial court found, on the facts above outlined, that McCullough had been placed on notice of the moral and financial irresponsibility of the purchasers of the stock, and the financial insecurity of Prendergast-Davies Co., Ltd., of the intention to merge and to loot American Beverage Corporation and then held them liable for events which occurred after January 14th. In substance, the trial court found fraud, lack of good faith, and negligence on the part of appellants. There was no basis in the record for any finding of actual fraud, and any finding of constructive fraud or of lack of good faith could only rest on the existence of a fiduciary relationship. The finding of negligence was likewise based on a conception that appellants' duties as controlling stockholders were those of a fiduciary. Upon the findings of fact the court concluded that appellants were liable to account for any profits, and to compensate American Beverage Corporation for all the acts of mismanagement after Feinberg obtained control. Upon the trial Feinberg was permitted to settle his liability on the basis of a reconveyance of the American Beverage Corporation stock so as to permit the reorganization of American Beverage Corporation.

Even if we were to assume for the moment that the court applied the proper rules of law as to the liability of controlling stockholders, under the present circumstances we would be compelled to make findings of fact different from those of the trial court, because, in our view, the inferences which the trial court drew from the facts proved are unwarranted. We fail to find any sufficient evidence of a warning to McCullough of a contemplated looting or how any investigation which McCullough could have made would have revealed the improper intentions and machinations of Feinberg. Undoubtedly the latter went to great length to hide from McCullough his real intentions by putting Clark into the forefront of the negotiations, and having Clark paint a picture of a new and larger company. The trial court stated in its opinion that there was no direct evidence that McCullough knew of Feinberg's intention to have American Beverage Corporation assume the liabilities of Prendergast-Davies Co., Ltd., and, thus, indirectly pay for the stock. The basis of the court's decision of breach of duty was that there were sufficient circumstances to put McCullough on guard as to Feinberg's wrongful intentions. To infer that McCullough was warned of an intention to loot American Beverage Corporation, and render it financially worthless, was to infer that he disregarded the effect that this would have had on the long and lucrative lease held by his family on the building occupied by American Beverage Corporation. If McCullough could have known of an intention to loot, then Stemmler was in even a better position to learn of this, yet Stemmler's family held considerable of the preferred stock of American Beverage Corporation, which would have been rendered valueless. While McCullough received a price for the 72,000 shares in excess of the price at which

small lots of the stock sold in the open market, he was receiving less than the book, or liquidating value of the stock, and he knew the very conservative basis on which the books of American Beverage Corporation were kept.

We think that the evidence discloses that McCullough believed up to the time his stock was actually sold that a larger merger was intended. In fact the trial court indicated in its opinion that this intention of forming a larger corporation by merger of American Beverage Corporation with several other companies might have been abandoned after the sale. If the real intentions of Feinberg were unknown to McCullough, or if the latter had no substantial warning thereof or of the intention to abandon the larger merger, then the whole theory on which the trial court placed liability fails. That there was no disclosure of abandonment, if in fact such a plan ever existed, is evidenced by the actions of Feinberg in placing Clark on the new board of directors. Doing this would lead McCullough to believe in the continuation of the grandiose scheme. The existence of new interests would, of course, have led McCullough to believe that there were sources available for the payment of the purchase price of $250,000 other than the treasury of Prendergast-Davies Co., Ltd. We think that the test of common sense and sound business judgment applied to this transaction would show that McCullough had no warning that American Beverage Corporation was in danger of being looted. He had substantial financial reasons because of the existing lease for not desiring to see any such result accomplished.

Under the circumstances we must reverse the findings of fact made, and conclusions drawn, which are inconsistent with our views as to the notice conveyed to McCullough. In the absence of such findings, reversal of the judgment would necessarily follow. This is so for in the absence of knowledge or notice there would be no basis for a holding that there was any breach of duty on McCullough's part or intention by him to act in hostility to the interests of American Beverage Corporation, or its minority stockholders. A holding that such a breach or intention to injure existed would be a prerequisite to any liability such as was imposed here. There was no evidence that McCullough conspired fraudulently to turn over control to a purchaser in order to enable him to loot the corporation. The trial court found no such conspiracy. It placed liability on the existence of a fiduciary relationship and breach of duties imposed thereby.

We doubt that the status of one owning a controlling block of stock can be said to be that of a fiduciary as to the sale of his holdings.

A stockholder, in selling his stock to a stranger, is not a trustee for other stockholders. This would seem to be so though a stockholder sold a majority of the stock.

In Gamble v. Queens County Water Co., 123 N.Y. 91, 25 N.E. 201, 9 L.R.A. 527, it was held that a stockholder in voting his stock is in no sense a trustee or representative of other stockholders. Corporate stock, it was said, might be voted in the light of what the owner considers his own interest. The court said that it is only where

the stockholder's interest is detrimental to the interests of the corporation and the action taken is a wanton and fraudulent destruction of the rights of the minority that the stockholder may be held to account. If this is so as to the voting of stock, it would seem to apply with equal, if not greater force to a sale of stock. By analogy, only a wanton and fraudulent destruction of the rights of the minority would seem to be actionable in the present situation. But even if we assume that the more rigid requirements of good faith or reasonable care are applicable, we find no breach of these requirements here.

Persons holding a majority of the stock of a corporation have the right and power to control the corporation within the limits of its charter powers. A sale of such controlling interest, of itself, perpetrates no wrong on anyone. Barnes v. Brown, 80 N.Y. 527, 537.

Stockholders are not ipso facto trustees for each other. Blaustein v. Pan American Petroleum & Transport Co., 263 App.Div. 97, at page 119, 31 N.Y.S.2d 934; Gamble v. Queens County Water Co., supra; Bell v. Fred T. Ley & Co., Inc., 278 Mass. 60, 75, 179 N. E. 294.

A majority stockholder does not become a fiduciary for other stockholders by reason merely of ownership of his stock. It is only where he steps out of his role as a stockholder, and acts in the management and conduct of the corporation, with disregard of the interests of the corporation and of the minority stockholders that he is said actually to become a fiduciary instead of a mere stockholder. Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148; Blaustein v. Pan American & Transport Co., supra. We may assume that he may be held as fiduciary when he is in active charge of corporate affairs, and induces a minority stockholder to sell his holdings, concealing the true condition of corporate finances for the purpose of making a personal profit. See Sautter v. Fulmer, 258 N.Y. 107, 179 N.E. 310. Such a state of facts would not be analogous to the present one.

The New York cases relied on by the trial court in its opinion, as supporting its holding there, would seem to have no application, for the reason that they involved the improper conduct of corporate affairs by those controlling a majority of the stock.

In Farmers' Loan & Trust Co. v. New York & N. R. Co., 150 N. Y. 410, 44 N.E. 1043, 34 L.R.A. 76, 55 Am.St.Rep. 689, the majority stockholder (another corporation) actually took over the management of the subsidiary, and diverted income from it, refusing business which would have been sufficient to pay interest on its obligations. Having thus permitted a default in interest, the majority stockholder instituted an action to foreclose, so as to obtain the property at less than its true value.

Bosworth v. Allen, 168 N.Y. 157, 61 N.E. 163, 55 L.R.A. 751, 85 Am.St.Rep. 667, involved misconduct by directors, and presented the question of their liability in such capacity.

In Kavanaugh v. Kavanaugh Knitting Co., supra, a dissolution of a prosperous corporation was involved at the instance of the majority stockholders. The court held that the determination of the ques-

tion whether the dissolution was wise was part of the corporate affairs, and the majority stockholders occupied a position of trust to the corporation, and were burdened with fiduciary obligations in making such decision. It was only in taking corporate action as to dissolution that the stockholders were held to be acting for each other, and thus prevented from acting for their individual advantage. In that case the Court of Appeals stated (226 N.Y. at page 194, 123 N.E. at page 151): "Undoubtedly no trust relation ordinarily exists between the stockholders themselves."

In the present case no claim was made that any of the affairs of American Beverage Corporation were mismanaged by appellants; nor was it claimed that the conduct of corporate affairs was directly involved in the sale of the stock.

The trial court relied largely on the decision in Insuranshares Corporation of Delaware v. Northern Fiscal Corporation, D.C., 35 F. Supp. 22. We think the case referred to is distinguishable upon the facts. There the sale of corporate control involved the transfer of the stock of an investment trust, the assets of which consisted entirely of readily saleable securities. Plenary power to sell the assets went with control. In the present case the company is a going mercantile concern, possessing plant, equipment, trademarks, good will, etc. In the Insuranshares case, supra, the transferors received a price beyond the intrinsic, or book value of their shares, which were capable of accurate measurement by consideration of the market value of the securities owned by the investment trust. Here the contrary appears. The controlling stockholders there agreed to convert part of the company's assets into cash before delivering control, and to secure the resignation of directors. No such agreements existed here. In addition, in the cited case the transferors were cognizant of the fact that a short time before the company had suffered a loss of many millions of dollars through a transfer of control to dishonest persons, and it was shown that the danger of a recurrence of this situation had been specifically called to the transferors' attention.

The present case does involve a charge that the majority stockholders benefited at the expense of the minority. That charge, however, rests solely on the claim that more was received by appellants for their stock than it was bringing in the open market. The difference between market price and liquidating value would indicate that the market price of small lots of stock did not reflect its intrinsic worth, especially of controlling stock. Realization of more than the market price would not, under such circumstances, be indicative of fraud, nor afford the minority stockholders any right of action. Nor would the fact that purchasers were willing to pay a larger price to one holding control necessarily make the receipt of an increased price improper or indicate any unlawful intention on the part of the purchasers. Control might have lawful advantages. For instance, if corporate control for the purpose of merger, or some similar object, was desired by the purchasers for legitimate purposes, undoubtedly they would pay more for a controlling interest. We see no reason why the value of control would not be a lawful property right of

the controlling stockholders, at least to the extent that it is reflected in the price they may obtain for their stock in an honest sale. In any event, in view of the liquidation value of the stock involved in the present case, the sum realized here could not be said to be so excessive as to indicate any danger signal.

Of course, a majority stockholder may not knowingly use his position to wrongfully injure one who holds a minority interest, and will incur liability when he does so. The test of common honesty would seem to be a sufficient one to apply in order to determine when a wrong is being done. To apply the rigid rules limiting a fiduciary, and to say further that the failure to investigate the moral character, or financial ability of the purchaser of one's stock is an actionable wrong, is to place an unwarranted burden upon the ownership of stock. Knowledge that the purchasers were about to loot the corporate treasury, or were persons who had previously engaged in such practices would be one thing. Concluding on the basis of mere lack of knowledge concerning the business integrity of the purchaser that the seller assumes the risk that the buyer has an intention to loot the company would be quite another. The law does not require one to act on the assumption that a person with whom a business transaction, even of large amount, is had, will commit a fraudulent or criminal act if given the opportunity to do so. Quite the contrary may be assumed, in the absence of actual notice.

In the present case there is no evidence that McCullough had any intimation that Feinberg was a man of bad repute. In fact, that Feinberg was such a person is not claimed. The theory of respondents in this case, seems to be that the person from whom Feinberg bought control of Prendergast-Davies Co., Ltd., was a man of such reputation. To say that a circumstance of this remote nature should prevent or deter the sale of one's stock, or create the duty of investigation, seems unwarranted in reason.

As we find no basis in fact or in law for the judgment appealed from, it becomes unnecessary to discuss the question of damages and other points raised.

The judgment so far as appealed from should be reversed with costs, and the complaint dismissed on the merits with costs.

All concur.

Judgment, so far as appealed from, unanimously reversed with costs, and the complaint dismissed on the merits with costs.

Settle order on notice, reversing the findings inconsistent with this determination, and containing such new findings of fact proved upon the trial as are necessary to sustain the judgment hereby awarded.

(b) Use of Control

HEIMBAUCH v. HITCHCOCK.

Supreme Court of Kansas, 1924. 115 Kan. 182, 222 P. 114.

MARSHALL, J. The defendant appeals from a judgment in favor of the plaintiff for $1,100 in an accounting between the plaintiff and the

defendant, stockholders in the Hutchinson Implement Company, a corporation organized under the laws of this state.

The corporation was organized with a capital stock of $10,000, consisting of 50 shares of common stock of the par value of $100 each and 50 shares of preferred stock valued at $100 each. C. O. Hitchcock owned all of the preferred stock and 46 shares of the common stock and controlled all the remainder of the common stock except 1 share owned by the plaintiff. In the course of time, the common stock reached a value of $1,100, while the preferred stock remained at par. In February, 1920, at a meeting of the stockholders, not attended by the plaintiff, it was voted to retire the preferred stock, held by the defendant, and to issue to him 50 shares of common stock in lieu thereof. A resolution to amend the charter of the corporation to that effect was then adopted. The preferred stock was canceled, and common stock was issued in its place. The effect of retiring the preferred stock held by the defendant Hitchcock and issuing to him common stock in lieu thereof was to increase greatly the value of the preferred stock and to decrease the value of the common stock from $1,100 to about $600 for each share. Afterward, C. O. Hitchcock contracted to sell to T. R. Withroder 100 shares of the common stock of the corporation. This included the share held by the plaintiff.

The journal entry of judgment contains findings of fact as follows:

"The court finds that the plaintiff is the owner of one certificate of stock in the Hutchinson Implement Company, said certificate of stock being No. 7, and dated the 28th day of December, 1916; that the value of said certificate of stock at this time is the sum of $1,100.

"The court further finds that the defendant C. O. Hitchcock sold the assets and stock of the Hutchinson Implement Company for $60,000; that there should be deducted from said sale the sum of $5,000, being the preferred stock in said company; and that the balance should be proportioned among the original stockholders of the common stock of 50 shares of said company, plaintiff's share amounting to $1,100."

The court rendered judgment—

"That the plaintiff do have and recover of and from the defendant the sum of $1,100, with interest at 6 per cent. from this date and for costs of this action taxes at $17.80; that plaintiff be required to deposit with the clerk of the district court his certificate of stock in the Hutchinson Implement Company, the same being certificate No. 7, to be delivered to plaintiff [defendant] upon the payment of said judgment."

In commenting on this case, the trial court said:

"It does not appear right and I do not think the law authorizes or will permit a transaction of the kind shown by the testimony in this case; that is, a transaction by which perferred stock worth $100 a share is converted into common stock worth $600 a share and reducing the then outstanding value of common stock at least one-half. I believe such a transaction is absolutely void. Especially is this true where it took the active co-operation and vote of the party owning the preferred stock as a director, officer, and stockholder to carry out such a scheme, and I, therefore, find for the plaintiff and hold that upon his surrendering his share of stock he would be entitled to one-

fiftieth of all·the other assets of the corporation whatever they may be, if any.

"I take it this suit is in effect a confirmance and ratification of the sale and transfer of Withroder by Hitchcock, and it is therefore in the nature of an accounting, and as he has in effect affirmed the sale he should upon payment of his proportion of the proceeds, deliver the stock if requested."

We quote from Fletcher, Cyclopedia Corporations, vol. 6. Section 3997, in part, is as follows:

"The right of the majority stockholders to control the corporation is subject to the qualification that they must act in good faith and for the interests of the corporation. Acts of a majority, whether a ratification of acts of corporate officers or original transactions, are not binding on the minority where fraudulent. * * *

"Fraud need not be shown as a fact nor need the individual stockholders be actuated by any fraudulent intent, but it is sufficient that the existence of fraud is the necessary legal inference from facts found."

Section 3998, in part, reads as follows:

"Of course, a majority of the stockholders, no matter how large, has no right to divert to itself assets of the company to the detriment of minority stockholders."

Section 3999 reads:

"The majority stockholders cannot divide the assets among themselves to the exclusion of the minority. This is so apparent that exhaustive citation of authority is useless."

In 3 Cook on Corporations (7th Ed.) § 662, subd. 3, is found a résumé of the law which governs the conduct of majority toward minority stockholders in corporations and which fully supports the rules stated by Fletcher.

Hitchcock, who controlled this corporation, could not, by the stock transaction in which he engaged, increase the value of the preferred stock held by him at the expense of the plaintiff.

The judgment is affirmed.

SOUTHERN PACIFIC COMPANY v. BOGERT et al.

Supreme Court of the United States, 1919. 250 U.S. 483, 39 S.Ct. 533.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Suit by Henry L. Bogert and others, as executors under the last will and testament of Walter B. Lawrence, deceased, and others, against the Southern Pacific Company. A decree for complainants (226 F. 500) was affirmed by the Circuit Court of Appeals (244 F. 61, 15 C.C.A. 489), and defendant brings certiorari. Henry J. Chase and others filed separate petitions in the Supreme Court praying leave to intervene. Decree modified, and cause remanded for further proceedings; the petitions to intervene being denied without prejudice.

MR. JUSTICE BRANDEIS delivered the opinion of the Court.

In 1888, and for some years prior thereto, the Southern Pacific Company dominated the Houston & Texas Central *Railway* Company,

electing directors and officers through one of its subsidiaries, which owned a majority of the Houston Company stock. In 1888, pursuant to a reorganization agreement, mortgages upon the Houston Company properties were foreclosed, and these were acquired by the Houston & Texas Central *Railroad* Company; the old company's outstanding bonds were exchanged for bonds of the new; all the new company's stock was delivered to the Southern Pacific; its lines of railroad were incorporated in the transcontinental system of that corporation; and the minority stockholders of the old Houston Company received nothing. In 1913 the appellees, suing on behalf of themselves and other minority stockholders, brought this suit in the Supreme Court of New York to have the Southern Pacific declared trustee for them of stock in the new Houston Company and for an accounting. The plaintiffs below being citizens and residents of New York, and the Southern Pacific, a Kentucky corporation, it removed the case to the District Court of the United States for the Eastern District of New York; and that court, after a hearing on the evidence, entered a decree for the plaintiffs. Bogert v. Southern Pacific Co., 226 Fed. 500. See, also, Bogert v. Southern Pac. Co. (D.C.) 215 F. 218, and Id. (D.C.) 211 F. 776. There had been issued by the old Houston Company 77,269 shares of stock, and by the new 100,000 shares. The decree declared that the Southern Pacific held for plaintiffs and other stockholders who intervened 24,347.9 shares in the new Houston Company, directed that it should deliver to them these shares and also in cash the sum of $702,336.61 (being the aggregate of all dividends paid thereon) and interest thereon from the times the several dividends were received, upon receiving from them 18,816 shares in the old Houston Company and also with each share of old stock delivered $26 in cash and interest thereon from February 10, 1891. This decree was affirmed by the Circuit Court of Appeals (Bogert v. Southern Pac. Co., 244 F. 61, 156 C.C.A. 489); and the case comes here on certiorari (245 U.S. 668, 38 S.Ct. 190, 62 L.Ed. 539).

In considering the many objections urged against the decree, it is important to bear constantly in mind the exact nature of the equity invoked by the bill and recognized by the lower courts. The minority stockholders do not complain of a wrong done the corporation or of any wrong done by it to them. They complain of the wrong done them directly by the Southern Pacific and by it alone. The wrong consists in its failure to share with them, the minority, the proceeds of the common property of which it, through majority stockholdings, had rightfully taken control. In other words, the minority assert the right to a pro rata share of the common property; and equity enforces the right by declaring the trust on which the Southern Pacific holds it and ordering distribution or compensation. The rule of corporation law and of equity invoked is well settled and has been often applied. The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors. If through that control a sale of the corporate property is made and the property acquired by the majority, the minority may not be excluded from a fair participation in the fruits of the sale. * * *

Third. The Southern Pacific challenges the claim for relief on the ground that it took the new Houston Company stock, not as majority stockholder, but as underwriter or banker under the reorganization agreement. The essential facts are these: While dominating the old company through control of a majority of its stock, the Southern Pacific entered into its reorganization, under an agreement by which the minority stockholders of the old company could obtain stock in the new only upon payment in cash of a prohibitive assessment of $71.40 per share (said to be required to satisfy the floating debt and reorganization expenses and charges), while the Southern Pacific was enabled to acquire all the stock in the new company upon paying an assessment of $26 per share (said to be the amount required to satisfy reorganization expenses and charges). The Southern Pacific asserts that, unlike the minority stockholders, it assumed an underwriter's obligation to take the new company's stock not subscribed for by the minority, and also guaranteed part of the principal and all the interest on the new company's bonds, which were given in exchange for those of the old company. But the purpose of the Southern Pacific in assuming these obligations was in no sense to perform the function of banker. It was to secure the incorporation of the Houston Railroad into its own transcontinental system. And it was never called upon to pay anything under its guaranty.

Fourth. The Southern Pacific contends that the doctrine under which majority stockholders exercising control are deemed trustees for the minority should not be applied here, because it did not itself own directly any stock in the old Houston Company; its control being exerted through a subsidiary, Morgan's Louisiana & Texas Railroad & Steamship Company, which was the majority stockholder in the old Houston Company. But the doctrine by which the holders of a majority of the stock of a corporation who dominate its affairs are held to act as trustee for the minority does not rest upon such technical distinctions. It is the fact of control of the common property held and exercised, not the particular means by which or manner in which the control is exercised, that creates the fiduciary obligation.

Fifth. Equally unfounded is the contention that the Southern Pacific cannot be held liable because it was not guilty of fraud or mismanagement. The essential of the liability to account sought to be enforced in this suit lies, not in fraud or mismanagement, but in the fact that, having become a fiduciary through taking control of the old Houston Company, the Southern Pacific has secured fruits which it has not shared with the minority. The wrong lay, not in acquiring the stock, but in refusing to make a pro rata distribution on equal terms among the old Houston Company shareholders. * * *

Seventh. The Southern Pacific also contends that the decree is erroneous because the effect is to give to the minority their pro rata share in the new Houston Company without their having made any contribution towards satisfying the floating indebtedness of the old; whereas the floating debt creditors had a claim against the property prior in interest to that of the old company's stockholders. Kansas City Southern Ry. Co. v. Guardian Trust Co., 240 U.S. 166, 36 S.Ct. 334, 60 L.Ed. 579; Northern Pacific Ry. Co. v. Boyd, 228 U.S. 482,

33 S.Ct. 554, 57 L.Ed. 931. The fact that no provision was made for the floating indebtedness is not a bar to the minority obtaining relief. They did not come into court with unclean hands because there were floating debt creditors unpaid. If any floating debts creditors have been illegally deprived of rights, it was not by the minority's acts. Whether the terms on which relief should be granted the minority should be affected by the fact that the Southern Pacific had, through a subsidiary, a large interest in the unpaid floating debt, presents a more serious question, which will be considered later. * * *

Ninth. The Southern Pacific objects to the terms of the decree also on the ground that, if the minority stockholders are held entitled to a pro rata share of the new company stock, it should be upon payment, not merely of the $26 per share required to meet reorganization expenses and charges, but also of the additional sum required to discharge the floating indebtedness. At the time of the reorganization there was outstanding a large floating indebtedness for which on May 17, 1889, judgments were recovered: by the Lackawanna Iron & Coal Company in the sum of $555,914.25; by Morgan's Louisiana & Texas Railroad & Steamship Company in the sum of $1,795,570.81; and by the Southern Development Company in the sum of $858,133.15. The last two companies held as collateral for their claims $880,000 of bonds of the old Houston Company, for which they later received in exchange bonds of a new company to be applied at their par value toward payment of the debts for which judgment had been recovered. The reorganization agreement provided in substance that the whole $10,000,000 of stock of the new company, if not taken by the old company's stockholders, should be divided pro rata among such of the floating debt creditors as should provide the cash required to pay the floating indebtedness and reorganization expenses and charges; but no floating debt creditor took advantage of this provision, and all were thus wiped out in the reorganization.

The Southern Pacific asserts that the Morgan Company was and still is its subsidiary; that it owned and now owns a large part of the stock of that corporation; and that through such stock ownership it is, in effect, a large floating debt creditor of the old Houston Company. It suggests also that it has paid out moneys to protect the property of the new company from other floating indebtedness. If the Southern Pacific had been allowed to retain all the stock in the new Houston Company, it would obviously lose nothing by the wiping out of its interest in the floating indebtedness of the old company; and any money expended by it in protecting the property of the new company would be fully reflected in the increased value of the stock therein, if it owned all. But, if part of the new company stock is taken from it and distributed among the minority stockholders, the Southern Pacific will lose and the minority stockholders will gain the pro rata increase in value of the new company stock, due to wiping out of the Southern Pacific's share in the floating debt and to its expenditures made for wiping out other indebtedness.

The Circuit Court of Appeals recognized that there was great force in this contention of the Southern Pacific, but overruled it because it "was never raised in the case by pleading or otherwise until an ex-

ception was taken to the report of the special master" and because "there is nothing in the record to show what, if anything, the Southern Pacific Company did give up." The memorandum filed by the district judge on settlement of the interlocutory decree indicates that some such contention was made then. At all events it was clearly made before entry of the final decree; and it does not appear that the minority stockholders were in any way prejudiced by the failure to make the exact contention earlier. There is no reason to believe that the parties cannot determine now, as easily as they might have done a few years ago, to what extent the floating indebtedness due the Morgan Company represents money in effect expended by the Southern Pacific for the benefit of the old Houston Company and to what extent the wiping out of any indebtedness and any expenditure made by the Southern Pacific in connection therewith will inure to the benefit of such of the minority stockholders of the old company as receive stock in the new. Some adjustment should obviously be made so as to compensate the Southern Pacific for any contribution made at its expense to the value of the stock in the new company of which the minority stockholders may get the benefit. The purpose of this proceeding is not to punish the Southern Pacific, but to declare and enforce its obligation as trustee. The minority stockholders who seek equity should do equity; and a court of chancery has power in granting relief to prevent unjust enrichment of the minority stockholders at the expense of the Southern Pacific. To determine the amount of such contribution by the Southern Pacific and of such benefit to the minority stockholders further investigation by the trial court will be necessary; and the judgments on the floating indebtedness entered in 1889 against the old company should not be held a bar to any inquiry into relevant facts. Whether this compensation shall be made by way of addition to the assessment of $26 per share provided for in the decree, or whether it can and should be made by requiring the minority stockholders to consent to the creation in favor of the Southern Pacific of some charge against or interest in the new company which would have priority over the 100,000 shares of stock outstanding, as, for instance, an income bond or preferred stock, or whether the compensation should be made in some other manner, should also be determined in the first instance by the District Court where all the relevant facts can be ascertained. The final decree must be set aside and the interlocutory decree be modified so as to provide for the necessary inquiry; and, when all the relevant facts shall have been ascertained, a final decree should be entered which will embody such terms as shall be found to be appropriate to afford to the Southern Pacific appropriate compensation for its contribution. * * *

Decree modified, and cause remanded to the District Court, for further proceedings in conformity with this opinion; the costs in this court to be equally divided between the parties.

WABASH RAILWAY COMPANY v. AMERICAN REFRIGERATOR TRANSIT COMPANY et al.

Circuit Court of Appeals of the United States, Eighth Circuit, 1925. 7 F.2d 335.

Suit in equity by the Wabash Railway Company against the American Refrigerator Transit Company and another. From a decree of dismissal, plaintiff appeals. Reversed and remanded, with directions.

This is an appeal from an order and decree of the District Court of the United States for the Eastern District of Missouri, dismissing, upon motions of the American Refrigerator Transit Company and the Missouri Pacific Railroad Company, appellees, appellant's amended bill of complaint.

For the purpose of passing on the assignments of error, the facts, well pleaded in the amended bill of complaint, must be accepted by us as true. They may be summarized as follows:

On or about February 14, 1881, the Missouri Pacific Railway Company, the St. Louis, Iron Mountain & Southern Railway Company (predecessors of the Missouri Pacific Railroad Company), and the Wabash, St. Louis & Pacific Railway Company (predecessor of appellant), organized under the laws of the state of Illinois, a corporation known as American Refrigerator Transit Company, with an authorized capital stock of $500,000, divided into 5,000 shares of the par value of $100 each; the said railroad companies at that time owning, or operating under leases, lines of railroad in Missouri, Kansas, Arkansas, and other states. The capital stock of the refrigerator company was issued to said three railroads in equal proportions, viz. one-third to each. Nothing was paid for said stock.

The said refrigerator company was organized for the purpose of creating therein a joint instrumentality or agency of the three railroad companies for carrying on the business affairs incident to the solicitation of perishable freight for transportation over the various lines of railroads owned and operated by said railroad companies, and for the operation and management of what was commonly known as refrigerator cars for the conserving in transportation of perishable freight.

The refrigerator company, owning no cars or other property, and, having no funds with which to carry on its operations, the Missouri Pacific Railway Company, the St. Louis, Iron Mountain & Southern Railway Company, and the Wabash, St. Louis & Pacific Railway Company contributed to it in equal proportions $50,000 to be used as a working fund, and turned over to it 100 refrigerator cars from each of said railroad companies, for the use of which the refrigerator company was to pay a rental of $5 per month per car. In 1887 the St. Louis, Iron Mountain & Southern Railway Company and the Missouri Pacific Railway Company placed 469 additional refrigerator cars with the refrigerator company for the same purpose and on the same terms as the original contribution.

A written contract was entered into July 1, 1881, between said refrigerator company and said railroad companies, which provided that the refrigerator company was to furnish to said railroad com-

panies refrigerator cars to transport over the lines of railroad operated by said companies goods requiring refrigeration, and in consideration thereof the refrigerator company was to receive one cent per mile for every mile that any refrigerator car furnished by it should be run over the respective lines of railroad, and further was to receive a commission of 12½ per cent. of the freight revenues which each railroad company should receive for the transportation of said goods over its lines.

On the same date, viz. July 1, 1881, the railroad companies entered into another contract (called a stockholders' contract) with each other and with the refrigerator company, in which it was agreed that, in order to provide a fair, just, and equal distribution among themselves of the profits arising from the business of said refrigerator company, there should first be paid from the earnings of said refrigerator company all the operating and other necessary expenses of every kind, including in said expenses rentals paid on leased cars, and that the sum remaining after payment of these expenses should be distributed among the railroad companies "in the proportion which the business done and money earned over the roads or lines of each party shall bear to the whole earnings of said first party during the period for which such distribution is made; the several parties hereto hereby agreeing to the payment of dividends in that proportion of their stock."

It was further provided by the contract that "all certificates of stock in the American Refrigerator Transit Company shall contain full reference to this agreement and be expressly subject to all of its provisions." * * *

During the years when the Missouri Pacific and Iron Mountain Companies were receiving the larger share of surplus earnings by reason of larger contributions thereto, the railroad companies and the refrigerator companies construed the original stockholders' contract and the stockholders' contract of January 1, 1894, as constituting an assignment to the railroad companies, respectively, of the surplus earnings of the refrigerator companies.

Each of said parties to said operating and stockholders' contract, and their successors in interest, acted upon the construction so given to said stockholders' contracts, by refunding and paying over to the three railroad companies the accumulated surplus earnings from year to year in the respective proportions that said three railroad companies contributed to the earnings of the refrigerator companies under the terms of the operating contracts.

This construction of the original stockholders' contract of 1881 and of the stockholders' contract of January 1, 1894, was not questioned until the time that the contributions of the Wabash Railroad Company to the earnings exceeded the combined contributions of the Missouri Pacific and Iron Mountain Companies.

In 1911 the appellee refrigerator company and the Missouri Pacific and Iron Mountain Companies for the first time asserted that the surplus earnings of the refrigerator company did not belong, either in law or equity, to the said three railroad companies in the proportion that said railroad companies contributed to such earnings, as provided for by the terms of the operating contract of January 1, 1894, or in any

other proportion, but that the surplus earnings of the refrigerator companies, which had been invested in refrigerator cars and other properties, had lost their character as surplus, and were no longer distributable to the stockholders on the basis of the stockholders' contract of January 1, 1894; that such cars or other property purchased in the name of the refrigerator companies, and wholly or partially paid for from surplus earnings, were owned and held by the refrigerator company, free and clear of any claim of title or interest, either legal or equitable, of the appellant or its predecessor, except such interest as appellant might have as a stockholder of appellee refrigerator company, without regard to, and independent of, the provisions of said stockholders' contract; and that, in any event, so much of the surplus as was derived by appellee refrigerator company, from earnings on railroad lines other than those of the stockholding railroad companies, should be distributed among the stockholding railroad companies on the basis of their respective stock ownership, and not upon the basis of the stockholders' contract of January 1, 1894.

The matter of controversy was in the year 1911 submitted by the Missouri Pacific Railway Company, the St. Louis, Iron Mountain & Southern Railway Company, and the Wabash Railroad Company, owners of all the capital stock of the American Refrigerator Transit Company, to one Lawrence Greer, Esq., as arbitrator, together with the statements of the respective claims and contentions of the parties to the controversy, "with the understanding and agreement that all parties would accept and abide by the facts and decision of said arbitrator."

We do not find in the record the arbitration agreement. The opinion of the arbitrator appears, however, as an exhibit to the amended bill. The arbitrator decided that the stockholding railroad companies were entitled to interest in the cars of the refrigerator company purchased by it out of the surplus revenues, which otherwise might have been distributed in payment of dividends, upon the same basis and in the same proportion as provided in the stockholders' contract of January 1, 1894, with respect to the distribution of surplus of the refrigerator company, and irrespective of whether such surplus was derived from business done over the lines of the stockholding railroad companies or of other railroad companies. * * *

KENYON, CIRCUIT JUDGE (after stating the facts as above). Wide divergence exists in the theories of the respective parties.

Appellees contend the suit is an attempt of a minority stockholder to recover against the corporation a definite portion of the corporate assets, on the theory that such assets represent deferred dividends which the board of directors should have declared but did not.

Appellant's theory is that the suit is not one to review corporate acts, or to bring about a dissolution of the refrigerator company, or to secure control of said corporation; that the question of discretionary power in the board of directors of said company is not involved, as the terms of the stockholders' contract of January 1, 1894, make mandatory the distribution of surplus earnings to the parties thereto in proportions there provided; that the action is one to declare and define

a trust relationship of the refrigerator company to the appellant and appellee Missouri Pacific Company and to compel the refrigerator company to carry on its business as such trustee according to the terms of the stockholders' contract of January 1, 1894, and the purposes of its creators. * * *

The contracts here were not only between the corporation and the stockholders, but were likewise contracts between the stockholders themselves. It is the general voice of authority that the stockholders of a corporation may contract with each other, and that such contracts will be valid, provided they do not involve the rights of creditors, violate statutes, or contravene public policy. Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559, Ann.Cas. 1918E, 247; Powers-Buchanan Co. v. Powers, 269 Pa. 388, 112 A. 541; Kantzler v. Benzinger et al., 214 Ill. 589, 73 N.E. 874; Hladovec v. Paul et al., 222 Ill. 254, 78 N.E. 619; Jones v. Brown, 171 Mass. 318, 50 N.E. 648; State ex rel. Frank et al. v. Swanger, 190 Mo. 561, 89 S.W. 872, 2 L.R.A.,N.S., 121, 4 Ann.Cas. 563; Fletcher's Cyc. of Corporations, vol. II, § 3673; Cook on Corporations, vol. 2 (6th Ed.) § 622, subds. a, b, and c. The contracts under consideration do not fall within any of these inhibitions. They were valid agreements, binding on the parties, their successors or assigns. * * * The amended bill states that, since January 1, 1894, the surplus revenues of the two refrigerator companies, except as applied to the payment of cars and other properties, have been distributed and paid over to the three railroad companies or their successors in the proportions that the contributions by each of said railroad companies to the gross revenues of the refrigerator companies bore to the total amount of the surplus revenues then to be distributed. The construction given a contract by both parties through a long term of years is persuasive in arriving at the intention and purpose of the contracting parties.

We reach the conclusion that the provision of the stockholders' contract of January 1, 1894, with reference to the distribution of surplus from all sources, was intended to include the earnings from foreign lines and any other outside sources, in addition to revenues derived from the business done over the lines of the railroad companies, signatories to the contract. If the expression, "surplus accruing from all sources," was not so intended, it would have been easy and natural to have so stated in the contract. It seems to us the expression used, in view of all the surrounding circumstances, is susceptible of no other construction. * * *

We are satisfied the amended bill of complaint states sufficient facts to give appellant a standing in a court of equity and to require an answer on the part of appellees. Its dismissal upon motion was error.

The case is therefore reversed and remanded, with directions to permit appellees to answer the amended bill of complaint, in default of which a decree should be entered for appellant substantially as prayed.

PART VI

STOCKHOLDERS' REMEDIES FOR MISMANAGEMENT

NEW YORK GENERAL CORPORATION LAW.

§ 60. *Action against directors or officers of corporation for misconduct.* An action may be brought against one or more of the directors or officers of a corporation to procure judgment for the following relief or any part thereof:

1. To compel the defendants to account for their official conduct, including any neglect of or failure to perform their duties, in the management and disposition of the funds and property, committed to their charge.

2. To compel them to pay to the corporation, or to its creditors, any money and the value of any property, which they have acquired to themselves, or transferred to others, or lost, or wasted, by or through any neglect of or failure to perform or other violation of their duties.

3. To suspend a defendant from exercising his office, for an abuse of his trust.

4. To remove a defendant from office and to direct the filling of the vacancy in accordance with the charter and by-laws of the corporation, or, if they contain no provision therefor, in such manner as the court shall direct.

5. To set aside a transfer of property, made by one or more directors or officers of a corporation, contrary to a provision of law, where the transferee knew the purpose of the transfer.

6. To enjoin such a transfer where there is good reason to apprehend that it will be made.

§ 61. *Who may bring such action.* An action may be brought for the relief prescribed in section sixty of this chapter, by the attorney-general in behalf of the people of the state, or except for the relief specified in the third and fourth subdivisions of said section by the corporation or a creditor, receiver or trustee in bankruptcy thereof, or by a director or officer of the corporation.

Upon the application of either party the court shall make an order directing the trial by jury of the issue of negligence, and for that purpose the questions to be tried must be prepared and settled as prescribed in section four hundred and twenty-nine of the civil practice act.

In any action brought by a shareholder in the right of a foreign or domestic corporation it must be made to appear that the plaintiff was a stockholder at the time of the transaction of which he complains or that his stock thereafter devolved upon him by operation of law.

§ 61-b. *Security for expenses.* In any action instituted or maintained in the right of any foreign or domestic corporation by the holder or holders of less than five percentum of the outstanding shares of any class of such corporation's stock or voting trust certificates, unless the

shares or voting trust certificates held by such holder or holders have a market value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which it may become subject pursuant to section sixty-four of this chapter, to which the corporation shall have recourse in such amount as the court having jurisdiction shall determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or is excessive.

NOTE

In Singer et al. v. State Laundry, Inc., et al., 188 Misc. 583, 68 N.Y.S.2d 808, 811 (Supreme Court, Special Term, New York County, 1947) Mr. Justice Shientag, commenting on § 61 of the General Corporation Law, said: "It will be noticed that the section does not require * * * that the stockholder must be a stockholder of record at the time of the transaction of which he complains. Under the Federal decisions on which the statute is modeled, it has been held that it is sufficient if the stockholder is equitably entitled to be such * * *" at the time of the transaction complained of.

DELAWARE GENERAL CORPORATION LAW

Sec. 51A. In any derivative suit hereafter instituted by a stockholder of a corporation organized under the laws of this State, it shall be averred in the Bill of Complaint that the Complainant was a stockholder of the corporation at the time of the transaction of which he complains or that his stock thereafter devolved upon him by operation of law.

FEDERAL RULES OF CIVIL PROCEDURE

Rule 23. Class Actions. * * *

(b) SECONDARY ACTION BY SHAREHOLDERS. In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.

(c) DISMISSAL OR COMPROMISE. A class action shall not be dismissed or compromised without the approval of the court. If the right sought to be enforced is one defined in paragraph (1) of subdivision (a) of this rule notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs. If the right is one defined in paragraphs (2) or (3) of subdivision (a) notice shall be given only if the court requires it.

A. STOCKHOLDERS' DERIVATIVE ACTIONS

1. WHAT STOCKHOLDERS MAY MAINTAIN SUCH ACTIONS

POLLITZ v. GOULD et al.

Court of Appeals of New York, 1911. 202 N.Y. 11, 94 N.E. 1088.

Action by James Pollitz against George J. Gould and others. From a judgment of the Appellate Division (127 N.Y.S. 1140), affirming an order denying a motion made on the pleadings to dismiss the complaint, defendants George J. Gould and others appeal by permission on certified questions. Affirmed, and questions answered.

HISCOCK, J. This action was brought by plaintiff as a stockholder in the Wabash Railroad Company in behalf of said company, for the benefit of himself and all other stockholders, to set aside as fraudulent a transfer and exchange of several millions of dollars par value of its stock for an equivalent amount of the capital stock of the Wabash Pittsburg Terminal Railway Company. It is unnecessary to go into the details of the transaction which is being attacked by the plaintiff through and in behalf of the company, for the sole question presented for our consideration may be discussed without doing this. This question is whether a stockholder may bring an action of this character for the purpose of avoiding an improper transaction consummated at the expense of the corporation before he acquired his stock, and as presented here the question is unembarrassed by any incidental considerations, such as that the prior holder of the stock consented to the transaction, or that plaintiff's subsequent acquisition of the stock was accompanied by any circumstances which render it inequitable for him to seek relief.

While somewhat strangely this question does not appear to have been decided by this court, it has been passed on by the lower courts of this state, and by those of many other states, and by the Supreme Court of the United States. It has also been somewhat considered by the courts of England. Conflicting conclusions have been reached by these decisions. Without reviewing the English authorities, which so far as cited do not seem to be very decisive, reference may be made to the decisions in this country.

The question was presented in Hawes v. Oakland, 104 U.S. 450, 26 L.Ed. 827, and it was there held that a stockholder might not bring an action in behalf of the corporation to avoid a fraudulent transaction consummated before he acquired his stock. While the ques-

tion was directly passed on, it is fair to state that it was not considered at any great length, and that the court seems to have been more concerned with establishing this rule as one of practice than of substantive law. The decision resulted in the adoption of a rule of practice requiring the plaintiff in such an action to show, before bringing suit, that he owned the stock on which it was brought at the time the transaction complained of occurred, and, whether it be regarded as establishing a principle of law or a rule of practice, this authority has been subsequently followed in the United States courts. In addition, this requirement of the plaintiff in such a stockholder's action has been approved in the following cases: Alexander v. Searcy, 81 Ga. 536, 8 S.E. 630, 12 Am.St.Rep. 337; Boldenweck v. Bullis, 40 Colo. 253, 90 P. 634; Rankin v. S. W. B. & I. Co., 12 N. M. 54, 73 P. 614; Moore v. Silver Valley Co., 104 N.C. 534, 10 S.E. 679; Clark v. American Coal Co., 86 Iowa 436, 53 N.W. 291, 17 L.R.A. 557; Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024, 60 L.R.A. 927, 108 Am.St.Rep. 716.

The contrary doctrine that a stockholder acquiring his stock subsequent to the occurrence complained of may maintain this character of an action has been affirmed in the following cases outside of this state: Winsor v. Bailey, 55 N.H. 218; City of Chicago v. Cameron, 22 Ill.App. 104, affirmed 120 Ill. 447, 11 N.E. 899; Montgomery Light Co. v. Lakey, 121 Ala. 131, 25 So. 1006; Forrester v. B. & M., etc., Co., 21 Mont. 544, 565, 55 P. 229, 353; Just v. Idaho, etc., Co., 16 Idaho 639, 102 P. 381, 133 Am.St.Rep. 140; Rafferty v. Donnelly, 197 Pa. 423, 47 A. 202; Appleton v. Am. Malting Co., 65 N.J.Eq. 375, 54 A. 454. It has also been approved in this state, directly or indirectly, in the following cases: Ramsey v. Gould, 57 Barb. 398; Young v. Drake, 8 Hun 61; Ervin v. Oregon Ry. & N. Co., 35 Hun, 544; Frothingham v. Broadway & Seventh Ave. R. R. Co., 9 N.Y.Civ. Proc.R. 304; Sayles v. Central Nat. Bank, 18 Misc.Rep. 155, 41 N.Y.S. 1063; O'Connor v. Virginia P. & P. Co., 46 Misc.Rep. 530, 535, 92 N.Y.S. 525.

Assuming this question to be an open one in this court, we have no hesitation in approving the rule, which has heretofore prevailed in this state, that in the absence of special circumstances this character of action may be maintained by a stockholder acquiring his stock subsequent to the transaction which is challenged, rather than the contrary one prevailing elsewhere. We do this, not only because a long and uniform line of decisions by our own courts ought to have weight, but because the rule established by these decisions seems to be the sounder one.

A stockholder has an indivisible interest in the property and assets of a corporation, subject to the discharge of its obligations. This indivisible interest, generally speaking, is represented by certificates of stock, and is transferred by their transfer. The general character of these certificates, and the effect of their transfer in passing the interest of the holder, is too well established and understood to require any discussion. As an original proposition it would seem to be clear that a right of action by or in behalf of the corporation for fraud, to set aside a conveyance of its assets, or to avoid obligations

imposed upon it, is part of its rights, property, and assets, in which a stockholder has this indivisible interest, transferable by the transfer of his certificates. I am unable to see any real or substantial distinction by virtue of which a stockholder, transferring his certificates, would transfer all of his indivisible interest in bonds or real estate on hand, but would not transfer his interest in a right of action to recover bonds or real estate which had been fraudulently withdrawn from the possession of the corporation, and which it was entitled to recover; and if the subsequent holder, by acquiring the certificates, does acquire such latter interest, it seems to follow that he may, if necessary, in behalf of the corporation, assert and prosecute an action to protect and enforce the same.

Brief reference may be made to some of the reasons advanced in opposition to this view. Counsel points out practical inconvenience which he says will result from its application, owing to the difficulties in tracing stock and distinguishing that which has not assented to the transaction from that which has, or from that which perhaps has been issued since its consummation. These arguments, however, are so counterbalanced by corresponding claims from the opposite standpoint as to be of little weight.

Again, it is argued that, if one buys stock subsequent to the transaction, he should be regarded as buying subject to it, and not be permitted to question it. If the prior holder should give binding consent to the transaction, this under certain circumstances undoubtedly would prevent the subsequent purchaser from questioning it. But, in the absence of special circumstances, I fail to see any principle of estoppel or logic which makes a subsequent purchase of stock so subject to a fraudulent corporate transaction that the purchaser may not insist upon its being set aside. There is scarcely any analogy between the situation of one who buys from an individual property which has been subjected to a transaction which has not been disaffirmed, and that of one who purchases stock in a corporation which has the continuing right, both before and after the purchase, to disaffirm a wrong which has been perpetrated on it by its agents. There is little or no basis for the practical consideration that one who buys stock should be deemed to have adjusted his price to an existing transaction, even though voidable. If he knows of it, he may just as properly be assumed to have adjusted his price to the knowledge that the transaction may still be disaffirmed and avoided.

Then, lastly, an argument is made which seems to be founded on the idea that, in order to bring an action of this nature, the stockholder must in effect disaffirm the corporate transaction, and that this disaffirmance involves a personal right of election, which vests in the one holding the stock when the transaction is consummated, and which cannot be transferred. It is said "the right to question a fraud is not a purchasable commodity," and is not "capable of assignment and transfer," and does not pass "as an implied incident to every sale of corporate stock," and this view seems to be supported by some of the many cases which have been collected and reviewed by counsel with manifest industry and care.

So far as this argument means to assert that a mere naked right to question a corporate transaction could not be transferred to a stranger, if such an attempt can be conceived of, it may be assumed to be true. But the assertion that the right to protect stock by procuring an improper corporate transaction to be vacated does not pass on a transfer of the stock is a very different proposition. The election to disaffirm a fraudulent corporate transaction belongs to and is exercised in the right and name of the corporation, and not of the stockholder. The stockholder demands that the right shall be exercised and the cause of action be prosecuted by the corporation, or does it himself for the corporation. It is conceded that the one holding the stock when the fraud is consummated has this right. When he transfers his certificates, the transaction still stands, a continuing wrong, impairing the surplus of the company and affecting the stock. If the transferee has the right to have it avoided, this will protect and increase the value of his stock. If he has not acquired this right, it is the only one held by his predecessor in or through the corporation, which has been thought of, which has not been transferred by the transfer of the stock. It will be an anomalous exception if the prior holder retains the right to maintain or have maintained this action, while he passes all of his other rights by the transfer of his stock.

The only justification pleaded for this is the idea suggested of a personal and non-transferable right of election to disaffirm vested in the original holder. But this theory is entirely unsubstantial. Such prior holder does not acquire this right to object to the transaction and bring an action to set it aside as a power conferred upon him by reason of any personal qualities, but because of his character as a stockholder, and when he loses this character, and transfers it to another with his stock, there is no reason why the latter should not exercise the right as a proper and necessary incident to and for the benefit of his stock ownership.

The order should be affirmed, with costs, and both questions certified to us answered in the negative.

Order affirmed.

NOTE

The common-law rule in New York was subsequently changed by statute (see supra N. Y. General Corporations Law, § 61). Judge Hiscock's opinion nevertheless states the case for the classic conception. Why should sale of a share of stock transfer to the purchaser a smaller bundle of rights than was included in the share while it remained in the hands of the seller?

The so-called Federal Rule (requiring that the complainant in a derivative action shall have been a shareholder at time of the transaction attacked) is now, nevertheless probably the prevailing rule. See, for the best statement in favor of this rule the opinion of Dean Pound, then sitting on the Nebraska bench, in Home Fire Insurance Company v. Barber et al., 67 Neb. 644, 93 N.E. 1024 (Nebraska, 1903.)

PARSON et al. v. JOSEPH.

Supreme Court of Alabama, 1891. 92 Ala. 403, 8 So. 788.

Appeal from Chancery Court, Jefferson County.

COLEMAN, J. The purpose of the bill is to have certain certificates of stock issued by the Birmingham, Powderly & Bessemer Street Railroad Company to defendant Parson canceled, on the ground that the stock is fictitious, and was issued in violation of the constitution and statute law of the state. The bill prayed an injunction, and the writ was awarded by the chancellor. A demurrer was interposed, and also an answer by the defendant Parson. The cause was submitted for decree on the demurrer, and upon motion to dissolve the injunction. The court overruled the demurrer, and denied the motion to dissolve the injunction, and from this interlocutory decree the appeal is taken. Among other averments, the bill substantially alleges that plaintiff is a *bona fide* stockholder in said company; that shortly after the organization of the company the defendant subscribed for 107 shares of the capital stock of the company, of the par value of $50 each, and paid for the same in full by conveying to the company 39 acres of land, (describing the land,) at an agreed price and valuation of $137 per acre, when the land was not worth more than $25 per acre, and for this land Parson was to receive 107 shares of the stock; that shortly thereafter the capital stock of the company was doubled, and, without further consideration than the 39 acres of land, Parson's stock was doubled, and he received 214 shares of the capital stock. The bill, as amended, charges that the excessive valuation of the land was made knowingly, willfully, and with the fraudulent intent of having issued to Parson the fictitious stock, in violation of law. * * *

The answer denied that plaintiff was a *bona fide* stockholder, and set up that plaintiff was the transferee of one E. Lesser. The answer admits that defendants' stock was doubled without the payment of any additional consideration than that of the land; but, by way of explanation and defense, avers the lands were not truly and properly valued at first, and the increased valuation of the lands only raised them to their real and true value, and the additional issue of stock was for property at its fair valuation. The answer continues, however, as follows: That if said transaction had been illegal and fraudulent, and not done in good faith, complainant is estopped from setting up fraud in said transaction, or seeking to cancel said stock, because E. Lesser, who was complainant's transferrer, participated in all of said transactions, and himself fixed the value of said lands, with full knowledge of, and after full investigation of, the value of said land. A transferee of stock is not necessarily disqualified as a suitor in all cases, because the prior holders were personally disqualified. If the transferee purchased the shares in good faith, and without notice of the fact that the prior holder had precluded himself from suing, he would have as just a title to relief as if he had purchased from a shareholder who was under no disability; but if the purchaser was aware that the prior holder had barred his right to

relief, neither justice nor public policy would require that the transferee, under these circumstances, should be accorded any greater rights than his transferrer. Id. § 267. The same rule prevails in this state in favor of derivative purchasers. A claimant who was a *bona fide* purchaser, without notice of a fraud, or of facts which the law considers sufficient to establish it, or from which it is inferable, then he could not be affected by a notice to his vendor. Horton v. Smith, 8 Ala. 78; Fenno v. Sayre, 3 Ala. 458; Wier v. Davis, 4 Ala. 442; Martinez v. Lindsay, ante, 787; Wait, Insolv. Corp. §§ 628, 630. If a stockholder participates in a wrongful or fraudulent contract, or silently acquiesces until the contract becomes executed, he cannot then come into a court of equity to cancel the contract, and more especially if the company or himself as a stockholder has reaped a benefit from the contract; and this rule holds good, although the consideration of the contract may be one expressly prohibited by statute. The same disability would attach to the transferee of his stock who bought with notice. We consider this general rule of equity abundantly sustained. Mor. Priv. Corp. §§ 261, 262; Cook, Stocks, §§ 39, 40, 735; Wright v. Hughes, (Ind.) 21 N.E.Rep. 907. It is sustained by the familiar rule that he who invokes the aid of a court of equity must have clean hands. Mr. Cook states the conditions upon which a stockholder can sustain a suit to remedy the frauds, *ultra vires* acts, or negligence of directors to be—*First,* the acts complained of must be such as to amount to a breach of trust, and such as neither a majority of the directors nor of the stockholders can ratify or condone; *second,* that the complaining stockholder himself is free from laches, or acquiescence in the acts to remedy which the suit is brought; *third,* that the corporation has been requested, and refused or neglected, to institute the suit, that the suit is instituted by *bona fide* stockholders as complainants, and that the corporation and the guilty parties, and other proper parties, have been made defendants. Cook, Stocks, § 646. If the averments of the bill are sustained by proof, the stock issued to the defendants was in violation of section 1662 of the Code, and of section 6, art. 14, of the constitution. On the contrary, if the proof shows that the property was received in payment of stock, at a fair valuation, such would not be the result. Davis v. Chemical Co., (Ala.) ante, 496. In cases where the stockholders or the company, by any laches, acquiescence, or participation in the unlawful and fictitious issue of stock, or for any other sufficient cause, are precluded from instituting the proper proceedings to remedy the wrong, the remedy is still open to the state to institute all necessary and proper proceedings to vacate and dissolve the corporation, or have such other proper judgments and decree rendered as the proof and justice may demand. It may be that stockholders who knowingly and intentionally have subscribed and paid for stock with property upon a fictitious valuation are liable as stockholders who have not paid up in full for their stock, within the meaning of the statute, to creditors who have not precluded themselves from maintaining the suit. Wait, Insolv. Corp. § 593; Douglas v. Ireland, 73 N.Y. 100; Boynton v. Andrews, 63 N.Y. 93. Applying the rule of law applicable when a motion to dissolve an injunction

is submitted upon bill, exhibits, and answer, and considering only so much of the answer as is responsive to the bill, we are of opinion that the decretal order, overruling the demurrers and motion to dissolve the injunction, is free from error.

Affirmed.

BOLDENWECK v. BULLIS et al.

Supreme Court of Colorado, 1907. 40 Colo. 253, 90 P. 634.

GABBERT, J. * * * The boards of the respective companies authorized the defendant King to make the contract he did and execute the conveyances attacked. Plaintiff purchased his stock in the Consolidated Stanley Mining Company subsequent to the meeting of the stockholders of that company which authorized King to dispose of its property. It appears to be stock which participated in that meeting, and voted in favor of the transaction which he now seeks to have set aside. Stockholders who vote in favor of a transaction and their transferees cannot maintain a suit on behalf of the corporation and other stockholders to avoid such transaction. Gumaer v. Cripple Creek T., T. & M. Co. (Colo.Sup.) 90 P. 81; 1 Cook on Stockholders, § 40; 2 Cook on Stockholders, § 735. It does not appear from the record that the stock of plaintiff in the Salisbury Mining & Milling Company voted to authorize King to dispose of the property of that company. It does appear, however, that he purchased this stock and his stock in the Consolidated Stanley Mining Company after the transactions attacked were consummated. Inasmuch as his ownership of the stock in both companies was not vested in him at the time of the transactions which he now seeks to avoid, and such ownership did not result by operation of law, he is not in a position to successfully attack them. Hawes v. Oakland, 104 U.S. 450, 26 L. Ed. 827; United El. S. Co. v. La. E. L. Co. (C.C.) 68 F. 673; 2 Beach on Corp. § 437; Alexander v. Searcy, 81 Ga. 536, 8 S.E. 630, 12 Am. St.Rep. 337; Dimpfel v. O. & M. R. Co., 110 U.S. 209, 3 S.Ct. 573, 28 L.Ed. 121. Purchasing stock in a corporation for the purpose of making it the basis of litigation with respect to past transactions ought not to be encouraged.

There are additional reasons why he should be estopped from questioning the transactions under consideration. Very shortly after the deal with the Stanley Consolidated Mining & Milling Company was consummated he knew of the fact. He was present at a meeting of the stockholders of the Consolidated Stanley Mining Company at which a report was submitted by the defendant King of the deal with the Stanley Consolidated Mining & Milling Company. He made no objection to the report, but refused to vote his stock. It appears that Reidel and Torrey have disposed of some of the stock of the Stanley Consolidated Mining & Milling Company. It also appears that this company has incurred obligations. If the transactions with this company were now avoided, the result would be that its stock and obligations would be worthless. To entitle stockholders to relief against the action of a corporation, they must bring suit within

such time after the doing of the acts complained of that the court may stop, or undo, the wrong of which they complain, without doing wrong to some other person; or, in other words, if a stockholder wants protection against the consequences of an act of the corporation, he must ask for it with sufficient promptness to enable the court to do justice to him, without doing injustice to innocent third parties. Levin v. Chicago G. L. & C. Co., 64 Ill.App. 393. * * *

MATTHEWS et al. v. HEADLEY CHOCOLATE CO.

Court of Appeals of Maryland, 1917. 130 Md. 523, 100 A. 645.

Bill by the Headley Chocolate Company against Henry W. Matthews and others. From an order overruling defendants' demurrers, they appeal. Order affirmed, and cause remanded for further proceedings.

BOYD, C. J. * * * The bill is peculiar in several respects, but particularly in the fact that it is not shown how many shares of stock were owned by the defendants, or how many by minority stockholders, or indeed how many Matthews sold, except that it was a controlling interest. It is not in terms alleged that there were any minority stockholders, outside of some of the defendants, but it does in several places speak of "minority stockholders," and it may be inferred that there were some, other than the defendants, who held shares, although, as far as the bill shows, they may have had 2,200, or more. As it is not alleged that the books of the company are not in its possession, the court should have been informed as to how the stock was held, for although the authorities are not uniform on the subject, we can have no doubt that if the holders of all the shares of stock assented to such payments to the officers as are here complained of, and a controlling interest in the company was afterwards transferred, the corporation could not recover the same, or any part thereof—at least unless it was shown that creditors were or might be affected by the payments. If the owners of most of the stock took part in or gave their assent to such payments, it is difficult to understand upon what principle a court of equity should give its aid to any other than minority stockholders, who had no part in the payments or had not acquiesced therein, unless there are creditors or other innocent parties to be protected through proceedings by the corporation. * * *

UNITED STATES LINES, Inc., et al. v. UNITED STATES LINES CO. et al.

CHAPMAN v. INTERNATIONAL MERCANTILE MARINE CO. et al.

Circuit Court of Appeals of the United States, Second Circuit, 1938. 96 F.2d 148.

Suit by the United States Lines, Inc., on behalf of itself and all other stockholders of the United States Lines Company similarly sit-

uated, against the latter company and others to assert claims of defendant corporation against the International Mercantile Marine Company and others, compel accounting by various defendants for certain payments and charges, and allow a dividend on complainant's junior preferred stock in the United States Lines Company. From orders denying petitions by Theodore S. Chapman for leave to prosecute the suit on behalf of complainant, denying his motion to enjoin discontinuance of the suit and discontinuing it, petitioner appeals.

Order of discontinuance reversed, appeals from order denying petition for leave to prosecute suit, and motion to enjoin discontinuance thereof dismissed, orders denying second petition for leave to prosecute and discontinuing suit reversed, and suit remanded to the District Court, with directions.

AUGUSTUS N. HAND, CIRCUIT JUDGE. The defendant United States Lines Company has been engaged since on or about December 8, 1931, in the business of owning and operating a transatlantic line of steamers which had been operated prior to that date by the complainant United States Lines, Inc. In February, 1934, United States Lines, Inc., brought a derivative stockholders' suit against United States Lines Company to assert claims that the latter corporation is said to have had against International Mercantile Marine Company, the American Lines Company, and the Roosevelt Steamship Company, Inc. (corporations which International controlled through stock ownership), against the Tide Water Oil Company, and also against various officers and directors of the corporate defendants other than Tide Water Oil Company. The derivative suit was based upon the ownership by United States Lines, Inc., of 600,000 shares of convertible junior preferred stock of United States Lines Company, which was the sole asset of United States Lines, Inc.

The complainant in the derivative suit by United States Lines, Inc., alleged the right of the United States Lines Company to recover several millions of dollars from the International Mercantile Marine Company and the corporations which it controlled, as well as from the individual defendants. The interests which obtained control of the United States Lines, Inc., made an attempt (hereinafter described) to have the derivative suit abandoned. In opposition to this attempt one of the counsel who had filed the bill and had been prosecuting the suit submitted an affidavit setting forth the nature and extent of the claims of the United States Lines Company against the other defendants herein. He stated that by means of the control of International Mercantile Marine Company over United States Lines Company (1) the latter had improperly agreed to pay the Roosevelt Steamship Company, Inc., an excessive management commission of 7-1/2 per cent., amounting to $696,429.78 for the year 1932 and to larger sums for each of the succeeding years; (2) that the United States Lines Company had entered into a contract with the Tide Water Oil Company to purchase quantities of oil from the latter at a cost of $75,000 more per year (amounting altogether to $600,000) than the price offered for similar oil by the Gulf Refining Company and had paid such excessive amounts to Tide Water; (3) that the United States Lines Company had made payments aggregating $300,-

000 for services not properly chargeable to it; (4) that excessive depreciation had been charged against the property of United States Lines Company to the amount of $800,000 per annum, thus impairing the dividend possibilities of the convertible junior preferred stock owned by United States Lines, Inc. The complaint prayed that the various defendants connected with the above payments and charges should account for the same and that a dividend of 37-1/2 cents should be decreed to the holder of the junior preferred stock. Answers were interposed by the defendants denying all liability. * * *

It is evident from the foregoing that the International Mercantile Marine Company in the year 1935 became in control of United States Lines, Inc., through the transfer of the latter's stock by the Chemical Bank, and had prior to that time come into control of United States Lines Company.

On October 5, 1935, the board of directors of United States Lines, Inc., instructed its attorneys in the derivative stockholders' suit to take no action and to incur no further expense in connection with the prosecution of the suit until receiving further instructions. J. V. Bendus, one of the directors of United States Lines, Inc., who was not a defendant in the suit or a director of any of the corporate defendants sued therein, but a holder of preference stock of United States Lines, Inc., notified the attorneys to disregard the instructions of its board of directors and to proceed vigorously with the prosecution of the suit. At about the same time the petitioner, Theodore S. Chapman, a brother of P. W. Chapman and an owner of 2,000 shares of preference stock of United States Lines, Inc. filed a petition, setting forth the attempt of those in control of the latter company to prevent the prosecution of the suit against them and their corporations and praying that he might be authorized to prosecute the suit at his own expense in the name of United States Lines, Inc., and that its directors should be enjoined from interfering with such prosecution and for other and further relief. Upon the petition and the affidavits submitted in support of and in opposition to the same, Judge Knox denied the application with leave to renew.

On June 12, 1936, Theodore S. Chapman renewed his application for leave to continue the derivative suit of United States Lines, Inc. The defendants opposed his petition by showing that on March 10, 1936, the stockholders of United States Lines, Inc., had held an annual meeting at which Mr. Bendus was appointed chairman of a committee to examine and report to the stockholders at an adjourned meeting regarding the disposition of the derivative suit. He was, by resolution, authorized to appoint two associates as members of such committee from among the minority preference stockholders who were not interested as defendants in the suit. The committee thus constituted consisted of three disinterested preference stockholders. After the investigation of the Bendus committee, and in conformity with its recommendation, the stockholders voted at an adjourned meeting of the corporation held on June 5, 1936, that the derivative suit should be discontinued and that, upon such discontinuance, the United States Lines, Inc., should give to each of the holders of the 600,000 shares of preference stock of that company

the opportunity to exchange their preference stock, share for share, with an equal number of shares of the junior preferred stock of United States Lines Company; that such exchange should be without expense to the stockholders (other than International Mercantile Marine Company) of United States Lines, Inc., for state and federal transfer taxes, or for corporate fees, counsel fees, and costs of notification to the stockholders, such expense to be borne by one or more of the defendants in the derivative suit. The expenses for corporate fees and counsel fees were stated by appellees to amount to about $40,000. The further expenses connected with the proposed exchange of stock were estimated by them at some $24,000 more.

The second application of Theodore S. Chapman for leave to prosecute the derivative suit at his own expense and to enjoin discontinuance was denied by Judge Bondy on October 5, 1936, who on April 8, 1937, made an order discontinuing the suit.

The vote of the stockholders' meeting which approved the settlement of the derivative suit recommended by the Bendus committee was as follows:

Vote for the settlement: 915,000 shares of the common stock, of which the total issue was 1,000,000 shares; 347,586 shares of the preference stock, of which the total issue was 600,000 shares.

Vote against the settlement: 3,550 shares of the preference stock.

Theodore S. Chapman contends that the votes upon the 915,000 shares of common and the 330,442 shares of preference stock of United States Lines, Inc., owned by International Mercantile Marine Company, the votes upon the 4,571 shares of preference owned by United States Lines Company, upon the 1,000 shares of preference owned by P. A. S. Franklin, upon the 3,500 shares of preference owned by Cletus Keating, upon the 3,460 shares of preference owned by or represented by A. P. Palmer, the secretary of International as proxy, and upon the 25 shares of preference owned by R. M. Hicks, the treasurer of International, ought not to be counted in determining whether the report of the Bendus committee was properly adopted for the reason that they were within the control of International Mercantile Marine Company against which the suit was brought, or in any event belonged to persons closely connected with it or its affiliates. But, if the votes of preference stock which are challenged be disregarded, nevertheless those of owners of that stock who were in no way connected with the defendants against whom charges were made in the suit would stand 4,456 in favor of the settlement recommended by the disinterested committee and 3,550 only against it. On no theory can we see any objection to counting the votes of 1,670 shares cast for the settlement by members of the Bendus committee when tabulating the votes.

The justification for allowing a double derivative suit like the present to be maintained is that both the original corporation that is said to have suffered wrong and its shareholder corporation which had the right to bring a derivative suit were in the control of those charged with inflicting the corporate injury. No attempt was made to extinguish any claim which United States Lines Company had against the alleged wrongdoers but only to abate the derivative suit

and to bar Theodore S. Chapman from prosecuting it even though he offered to do so at his own expense. There is no way of estimating the value of the claims and no attempt has been made to settle them but only to settle the derivative suit by paying the debts of the United States Lines, Inc., estimated at $40,000 at most and by paying the expense of distributing the assets of the latter corporation; namely, 600,000 shares of junior preferred stock of United States Lines, Inc. The proposal of the defendants to pay the expenses of exchanging the preference stock of United States Lines, Inc., for the junior preferred shares of United States Lines Company would benefit neither corporation but only eliminate a holding company from the picture. There is no showing that the creditors of United States Lines, Inc., propose to seize its only asset on execution or that the 600,000 shares of junior preferred stock will have any value unless the assets of United States Lines Company can be augmented by some realization upon the claims against the defendants. While the suit which has been brought seems highly speculative, yet the claims asserted run into millions and we are not satisfied that the value of the consideration offered for the discontinuance is sufficient to justify the order of the court below, especially when the discontinuance would apparently still leave Chapman free to institute another derivative suit as soon as he became a stockholder of United States Lines Company. Inasmuch as there are charges, however unjust they may be, that the corporate defendants appropriated moneys which should inure to the benefit of United States Lines Company, we think Chapman ought to be given his day in court, provided he conducts the proceeding at his own expense and shall receive indemnity only from any recovery realized through the suit and only then to a reasonable amount. As we have said, no consideration was offered to the United States Lines Company for the abandonment of the suit and its claims have not been extinguished. Under the circumstances, to require the discontinuance of the derivative suit for a relatively small consideration, when the claims sought to be asserted through it are enormous, does not seem justifiable. The settlement recommended by the committee did not involve any consideration moving to the company wronged, nor did their report indicate that they had investigated the claims for appropriation of assets arising out of the alleged overcharges and found them worthless or unsubstantial. The settlement accomplished little more than to block a proceeding by a persistent stockholder who sought to have claims of United States Lines Company against the defendants asserted when both it and United States Lines, Inc., were under their control.

We do not say that the stock owned by the defendants could not be voted in favor of the settlement, but hold that the settlement effected by a majority consisting mainly of the defendants who were in control of the corporation should not be sanctioned without clear proof that it was advantageus to the corporation and its stockholders. We are not satisfied that such proof has been furnished by the defendants. Heim v. Jobes, 8 Cir., 14 F.2d 29, 32; Geddes v. Anaconda Copper Mining Co., D.C., 197 F. 860, 865; Eagle Iron Co. v.

Colyar, 5 Cir., 156 F. 954; Mumford v. Ecuador Development Co., C.C., 111 F. 639, 643.

The order of discontinuance should be reversed and vacated and the intervener Chapman should be authorized to prosecute the suit in the name of United States Lines, Inc., but at his own expense, with a right to reasonable indemnity out of any recoveries which may be realized by the United States Lines Company through the prosecution of the suit, and other stockholders of United States Lines, Inc., should have the right to apply to the District Court for leave to join Chapman in such prosecution provided they are willing to contribute. The District Court may dismiss the suit at any time if it is shown that Chapman is not prosecuting it diligently.

The appeals from the order of Judge Knox denying Chapman's right to prosecute with leave to renew, and from the order of Judge Bondy denying the motion to enjoin the discontinuance of the suit, are dismissed because the decisions are now moot. The appeals from the orders of Judge Bondy denying leave to prosecute and discontinuing the suit are reversed. The suit is remanded to the District Court, with directions to proceed therein in accordance with the views expressed in this opinion. The appellant is allowed costs of the appeal.

2. WHERE DIRECTORS OR CORPORATION DEEM ACTION INEXPEDIENT

CONTINENTAL SECURITIES COMPANY et al. v. BELMONT et al.

Court of Appeals of New York, 1912. 206 N.Y. 7, 99 N.E. 138.

Action by the Continental Securities Company and Clarence H. Venner, stockholders in the Interborough Rapid Transit Company, on behalf of themselves and of other stockholders similarly situated, and on behalf of the company against August Belmont and others, impleaded with the Interborough Rapid Transit Company. From an order of the Appellate Division (134 N.Y.S. 635) affirming an order denying a motion by certain of the defendants for judgment upon the pleadings, defendants, other than the Interborough Rapid Transit Company, appeal by permission. Order affirmed, and certified questions answered in the affirmative.

CHASE, J. This is a representative action derived from the Interborough Rapid Transit Company. It is brought in behalf of the plaintiffs and all others similarly interested, as stockholders of said company, against the directors of said company and said company to require said individual defendants to account to said company for fifteen thousand shares of its capital stock, alleged to have been issued fraudulently and illegally, and without any valid or adequate consideration therefor, but upon an alleged consideration that was a pretense and subterfuge and intended to cover a gift or bonus to the defendants Belmont and Luttgen, and their nominees, and also to require said individual defendants to account for the dividends which have been paid on said stock. It is alleged that by reason of the facts

set forth in the complaint the defendant corporation has suffered damage to an amount exceeding $4,500,000. Each of the defendants answered the complaint, and, after the answers were interposed, a motion was made for judgment upon the pleadings dismissing the complaint pursuant to section 547 of the Code of Civil Procedure, which motion was denied. An appeal was taken therefrom to the Appellate Division, where the order denying said motion was unanimously affirmed. Leave was granted by the Appellate Division to the defendants, other than the defendant company, to appeal to this court, and the following questions were certified:

"(1) Does the complaint state a cause of action?

"(2) Was the motion of the defendants for judgment against the plaintiffs on the pleadings rightfully denied?" * * * It appears from the complaint that each of the plaintiffs purchased his stock subsequently to the transactions complained of in the complaint. This court in the recent case of Pollitz v. Gould, 202 N.Y. 11, 94 N.E. 1088, has definitely determined that a stockholder may bring an action in behalf of the corporation for the benefit of himself and all other stockholders to set aside as fraudulent an improper transaction consummated at the expense of the corporation before he acquired his stock. * * *

It was not necessary for the plaintiffs to allege in the complaint that their predecessors in title did not assent to or acquiesce in the alleged fraudulent issue of said 15,000 shares of stock. It is not necessary to negative such assent or acquiescence in a fraud, unless it is otherwise to be presumed from the delay in bringing the action or generally from the allegations of the complaint. If it exists, it is a matter of defense. Sage v. Culver, 147 N.Y. 241, 41 N.E. 513; Pollitz v. Gould, supra. If the rule were otherwise, the objection to the complaint would not avail the defendants in this case because the allegations of the complaint amount to a negative of any assent by the plaintiffs or their predecessors in title to the transactions alleged in the complaint.

It is also claimed by the appellants that it does not appear from the complaint that the defendant corporation and its board of directors were requested to bring suit to recover said fifteen thousand shares of stock or the value thereof, or that said corporation or said board of directors neglected or refused to bring such action. It appears from the complaint that on the 12th day of March, 1910, the plaintiff corporation, then being the owner of the stock now owned by the two plaintiffs, delivered to the defendant corporation and to its officers and directors a written communication directed to said defendant corporation and its president and directors, calling attention to the fact of the issue and delivery of said 15,000 shares of capital stock for a grossly inadequate and illegal consideration, and requesting and demanding that suit be brought in behalf of the corporation and in good faith prosecuted against the incorporators of said company and members of its board of directors during the year 1902 and said firm of August Belmont & Co. to recover the damages suffered by reason of the action of the said incorporators and directors.

Said written communication also stated and provided as follows: "We hereby offer to properly indemnify the Interborough Rapid Transit Company against any damage or costs it may sustain as a result of bringing and prosecuting such suit. A copy of this letter is mailed to each director of the Interborough Rapid Transit Company. Unless within ten days from date you advise us that the request and demand herein will be complied with we shall conclude that you refuse." Thereafter the plaintiffs waited until May 4, 1910, when, no action having been commenced and no response having been made to said written communication, this action was commenced.

Upon the facts so alleged the plaintiffs treated the defendant corporation and its board of directors as having refused and neglected to bring such action and the allegations relating thereto are sufficient to sustain the complaint. Kavanaugh v. Commonwealth Trust Co., 103 App.Div. 95, 92 N.Y.S. 543.

On this appeal as on the motion at the Special Term and on the hearing of the appeal in the Appellate Division the allegations of the complaint are taken as true.

It is conceded that an action in equity cannot be maintained by the plaintiffs as individual stockholders for themselves and all others similarly interested, unless it is necessary because of the neglect and refusal of the corporate body to act.

It is necessary, therefore, in an action by the plaintiffs to set forth two things: First, a cause of action in favor of the corporation with the same detail of facts as would be proper in case the corporation itself had brought the action; second, the facts which entitle the plaintiff to maintain the action in place of the corporation. Kavanaugh v. Commonwealth Trust Co., 181 N.Y. 121, 73 N.E. 562; O'Connor v. Virginia Passenger & Power Co., 184 N.Y. 46, 76 N.E. 1082. It is not seriously contended that the complaint does not state a good cause of action in favor of the defendant corporation. It is insisted by the defendants that it was necessary for the plaintiffs, in addition to alleging a demand upon the defendant corporation and its board of directors to bring the action and their neglect and refusal to do so, to allege that they had given notice of the alleged fraud to the body of stockholders of the defendant corporation, and had demanded of said stockholders that some action be taken by them to redress the wrong, and that such body of stockholders had neglected and refused to take any action relating thereto. The cause of action belongs to the corporate body and not to the plaintiffs and other stockholders individually, nor to the body of stockholders collectively.

The board of directors represents the corporate body. It is provided by statute in this state that the affairs of every corporation shall be managed by its board of directors. * * *

The claim of the appellants that the body of stockholders has some immediate or direct authority to act for the corporation or to control the board of directors in the matters set forth in the complaint is based upon an erroneous conception of the duties and powers of the body of stockholders in this state.

As a general rule, stockholders cannot act in relation to the ordinary business of a corporation. The body of stockholders have certain au-

thority conferred by statute which must be exercised to enable the corporation to act in specific cases, but except for certain authority conferred by statute, which is mainly permissive or confirmatory, such as consenting to the mortgage, lease, or sale of real property of the corporation, they have no express power given by statute. They are not by any statute in this state given general power of initiative in corporate affairs. Any action by them relating to the details of the corporate business is necessarily in the form of an assent, request, or recommendation. Recommendations by a body of stockholders can only be enforced through the board of directors, and indirectly by the authority of the stockholders to change the personnel of the directors at a meeting for the election of directors. * * * Some of the reasons why the power vested in stockholders to elect directors is inadequate as a remedy for specific fraudulent acts are stated by Cook in his work on Stock and Stockholders, § 740, in which he says: "There has been considerable discussion as to whether the stockholder in addition to his request to the corporate officers to institute the suit should not also be required to attempt to induce the stockholders in meeting assembled to take action by directing the directors to bring suit, or by refusing to re-elect them at the next election. The facts, however, that the stockholders in meeting assembled cannot control the discretion of the directors in bringing such a suit, that the remedy of refusing to re-elect them involves delay, and the assumption that a minority of the stockholders can by the election control such a suit, that irreparable injury or the vesting of great financial interests may occur in the meantime, and that laches may arise as a bar to the stockholder's suit, have settled the rule that the stockholder's request to the corporate directors to institute the suit is sufficient. He need not also apply to a stockholder's meeting. * * * Although it is said that the authority of stockholders in the management of business corporations is exhausted when they elect the directors (Thompson on Corporations [2d Ed.] § 1178), nevertheless it is generally recognized that certain acts of boards of directors that are legal, but voidable, can be ratified and confirmed by a majority of the body of stockholders as the ultimate parties in interest and thus make them binding upon the corporation. Morawetz on Corporations (2d Ed.) §§ 625, 626. Such recognized authority in stockholders to ratify and confirm the acts of boards of directors is confined to acts voidable by reason of irregularities in the make-up of the board or otherwise or by reason of the directors or some of them being personally interested in the subject-matter of the contract or act, or for some other similar reason which makes the action of the directors voidable. No such authority exists in case of an act of the board of directors which is prohibited by law or which is against public policy. Kent v. Quicksilver Mining Co., 78 N.Y. 159.'

In any case where action is taken by stockholders confirming and ratifying a fraud and misapplication of the funds of the corporation by the directors or others the action is binding only by way of estoppel upon such stockholders as vote in favor of such approval. Morawetz on Corporations (2d Ed.) § 625. The distinction between acts that can and those that cannot be confirmed and ratified is shown in

the report of two frequently cited English decisions, namely, Foss v. Harbottle, 2 Hare, 461, and Bagshaw v. Eastern Union Railway Co., 7 Hare, 114. The former of these cases was limited to the approval of a legal but voidable act. In the Bagshaw Case, where the directors of a corporation had misapplied or were about to misapply certain moneys of the corporation, the court say: "No majority of the shareholders, however large, could sanction the misapplication of this portion of the capital. A single dissenting voice would frustrate the wishes of the majority. Indeed, in strictness, even unanimity would not make the act lawful. This appears to me to take it out of the case of Foss v. Harbottle, to which I was referred. That case does not, I apprehend, upon this point, go further than this: That if the act, though it be the act of the directors only, be one which a general meeting of the company could sanction, a bill by some of the shareholders on behalf of themselves and others, to impeach that act, cannot be sustained, because a general meeting of the company might immediately confirm and give validity to the act of which the bill complains."

It is the governing body or bodies of a corporation with power to enforce a remedy to whom complaining stockholders must go with their demand for relief. The governing body of corporations in this state, as we have seen, is the board of directors. A complaining stockholder must go to such board for relief before he can bring an action, unless it clearly appears by the complaint that such application is useless. If the subject-matter of the stockholder's complaint is for any reason within the immediate control, direction, or power of confirmation of the body of stockholders, it should be brought to the attention of such stockholders for action, before an action is commenced by a stockholder unless it clearly appears by the complaint that such application is useless. The decision reported in Hawes v. Oakland, 104 U.S. 450, 26 L.Ed. 827, and other similar decisions in the federal and state courts are not in conflict with the decision about to be rendered herein. In such cases, as in this case, it is asserted that an application to the body of stockholders is unnecessary when it is unreasonable to require it. If the body of stockholders has no adequate power or authority to remedy the wrong asserted by the individual stockholders, it is unreasonable and unnecessary to require an application to it to redress the wrong before bringing a representative action. See opinion of Carr, J., in the Appellate Division herein (Sup.) 134 N.Y.S. 635. See, also, Delaware & H. Co. v. Albany & S. R. R. Co., 213 U.S. 435, 29 S.Ct. 540, 53 L.Ed. 862. In this case, where the plaintiff alleges fraud and a substantial misappropriation of 15,000 shares of the stock of the corporation through a nominal purchase of property and the payment of a pretended claim for services, application to the body of stockholders was not necessary. * * *

Order affirmed.

GROEL v. UNITED ELECTRIC COMPANY OF NEW JERSEY et al.

Court of Chancery of New Jersey, 1905. 70 N.J.Eq. 616, 61 A. 1061.

Suit by Adam H. Groel against the United Electric Company of New Jersey and others for an accounting by the United Gas Improvement Company, as promoter of the United Electric Company, etc. Plea overruled.

See 60 A. 822. * * *

GARRISON, V. C. * * * The single point is whether a board of directors may prohibit a stockholder from bringing a suit in behalf of the corporation to recover moneys secretly made by a promoter out of the incorporation of the company, if in the judgment of the board it is inexpedient to bring such a suit.

There can be no question that promoters are liable to the corporation for profits secretly made by them in its promotion, and that such liability arises in cases where future allottees of stock are concerned. Knoop v. Bohmrich, 49 N.J.Eq. 82, 23 A. 118 (Van Fleet, V. C.; 1891); Plaquemines Trop. Fruit Co. v. Buck, 52 N.J.Eq. 219, 27 A. 1094 (Green, V. C.; 1893); Loudenslager v. Woodbury Heights Land Imp. Co. (Err. & App. 1899) 58 N.J.Eq. 556, 43 A. 671, affirming the principle established in the Court of Chancery in 55 N.J.Eq. 78, 35 A. 436 (Pitney, V. C.; 1896). There can be likewise no question that, where the corporation refuses to bring a suit, stockholders may sue in its behalf, joining it as a defendant. It is true that courts will not interfere, as a rule, with the management of corporations by the directors thereof, when they are acting within their powers and in good faith. But whether the directors are acting in good faith and as honest, diligent trustees, or not, will be inquired into by the courts at the instance of stockholders in cases like the present. "A stockholder has no standing in the court to prosecute such an action, except on the refusal of the directors, either actual or presumptive, to prosecute. But such refusal of the directors to prosecute must be an unjustifiable refusal." Willoughby v. Chicago Junc. Railways Co., 50 N.J.Eq., at page 667, 25 A. 280 (Green, V. C.; 1892).

In discussing those cases in which no application need be made, our Court of Errors and Appeals has held that the suit may be maintained without any application where the interest or bias of the directors makes it certain that, if it was made, it would be denied. Appleton v. American Malting Co. (Err. & App. 1903) 65 N.J.Eq., at page 377, 54 A. 455. In the case of Kessler v. Ensley (C. C.) 129 F. 397, at page 400, the court said: "Of necessity, then, the governing body in every intra vires matter has a discretion to determine what action to take on the stockholder's request to sue; and when the stockholder comes into court the first question it must determine is whether that discretion has been properly or improperly exercised." The Supreme Court of the United States reviewed the previous decisions concerning this matter, and announced the true rule, in the case of Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 23 S.Ct. 157, 47 L.Ed. 256. "This

court will examine the bill in its entirety and determine whether, under all the circumstances, the plaintiff has made such a showing of wrong on the part of the corporation or its officers and injury to himself as will justify the suit." And it likewise quoted with approval the following language: "The circumstances of each case must determine the jurisdiction of a court of equity to give the relief sought."

Viewing this case in the light of the principles which must be applied to it, and of the authorities which have been quoted, can it be said that the directors have shown justification for refusing to bring a suit to recover approximately $20,000,000 of stock improperly obtained by a promoter? Would it not clearly be held by any court to be a breach of trust for directors to neglect or refuse to recover, or seek to recover, such an amount of stock improperly obtained from it by a promoter? It is perfectly clear that, if the complainant sets forth a good cause of action and there is a right in the corporation to recover $20,000,000 of stock from the promoter, it is a clear breach of trust on the part of the directors not to proceed to recover the same. For them to reply that it is by them deemed inexpedient to do so is only to emphasize the breach of trust they are committing by not doing so. I am aware that counsel for the defendant argues that their unwillingness to bring the suit, and that which in their judgment makes it inexpedient to bring the suit, proceeds from their view that the suit cannot succeed. I think I have sufficiently expressed my idea that this issue is not present before me for determination. If, on the face of the bill, it appears that the complainant cannot succeed, then demurrer is the proper remedy. If the bill, however, does set up a good cause of action, then, as I have already pointed out, the plea does not set up any other facts excepting the passage by the directors of a resolution refusing to bring the suit because in their judgment inexpedient.

There was much argument before me upon issues which I do not find in the case; the defendant contending that it had sufficiently shown that the suit ought not to be brought because it could not be successful, and the complainant replying that the statements in the report of the committee, as incorporated into the plea, show clearly that there is a cause of action, and that the defendant has not, on the merits, shown any reason why the suit should not be brought. I do not stop to consider these questions for the reasons given. I find that the complainant sets out a cause of action, and that the defendant replies by plea that it deems it inexpedient to bring a suit for this cause of action, and that the complainant, its stockholder, is precluded by reason of this fact. I find that the principle to be applied is that the stockholder may appeal to the discretion of the court in this respect; and, upon considering the whole case, I do not think it appears that the defendant was justified in refusing to bring the suit, with the result that the complainant may proceed, and the plea must be overruled. * * * I will advise an order overruling the plea.

3. EQUITABLE CONTROL OF DERIVATIVE AND CLASS ACTIONS

(a) Settlement

CLARKE v. GREENBERG et al.

Court of Appeals of New York, 1947. 296 N.Y. 146, 71 N.E.2d 443.

Action by Stanley Clarke, as trustee of Associated Gas & Electric Company, against Adolph Greenberg and others to recover amount received by defendants in settlement of a stockholder's derivative action brought by defendants. From a judgment of the Appellate Division of the Supreme Court, 270 App.Div. 923, 62 N.Y.S.2d 609, entered May 17, 1946, unanimously affirming a judgment of the Supreme Court for defendants entered upon an order of the court at Special Term (Levy J.) which granted a motion by defendants for dismissal of the complaint upon the ground that it did not state facts sufficient to constitute a cause of action, plaintiff appeals.

Reversed in accordance with the opinion.

DYE, JUDGE. The challenge to the within complaint, for failure to state a cause of action, raises the question of whether a plaintiff in a stockholder's derivative action may be required to account to the corporation for moneys received in private settlement for discontinuance of the action.

The complaint alleges that the defendants commenced a stockholder's derivative action in behalf of the Associated Gas & Electric Company (called AGECO) entitled "Greenberg v. Mange et al." in which it was alleged that the defendants, as officers and directors, had so mismanaged its affairs that the company and its stockholders were damaged and prayed that an accounting be had, and that the court "impress a trust in favor of the Company (AGECO) upon all secret profits and gains obtained by any of the defendant directors," etc. No individual relief was asked except reimbursement for expenses. Later and before trial, a stipulation was made settling and discontinuing the action without notice to other stockholders and without approval of the court, by the terms of which Greenberg excuted releases in his individual and representative capacity and transferred and delivered his stock, having a market value of $51.88, to the defendant directors and defendants herein received from them the sum of $9,000.

The complaint in this action alleges that the defendants received the money "to the use of, and in trust for AGECO"; that they had failed to account to it or its trustee, the plaintiff herein, and had accordingly unjustly enriched themselves in the sum of $8,948.12 which, in equity, should be paid over to the plaintiff, and prayed judgment accordingly.

The Appellate Division unanimously affirmed the dismissal of the complaint by the Special Term which relied upon Manufacturers Mutual Fire Ins. Co. of Rhode Island v. Hopson, 176 Misc. 220, 25 N.Y.S.2d 502, affirmed 262 App.Div. 731, 29 N.Y.S.2d 139, affirmed 288 N.Y. 668, 43 N.E.2d 71 in which we refused to set aside a stipulation settling a stockholder's derivative suit and revive the action. That case was limited to the right to discontinue and it did not consider whether the

moneys received in settlement were impressed with a trust in favor of the corporation for which an accounting should be made.

The very nature of the derivative suit by a stockholder-plaintiff suing in the corporation's behalf suggests the application of the fiduciary principle to the proceeds realized from such litigation whether received by way of judgment, by settlement with approval of the court, which presupposes stockholders approval, or by private settlement and discontinuance of the action at any stage of the proceeding. Such action, we have held, belongs primarily to the corporation, the real party in interest [Citing cases.] and a judgment so obtained, as well as the proceeds of a settlement with court approval belongs to it and not the individual stockholder plaintiffs. [Citing cases.] While the stockholder-plaintiff, with such others as join with him, controls the course of the litigation at all stages of the proceeding before final judgment, he does not bind the nonparticipating stockholders by his action, or deprive them of their own right of action against the unfaithful directors, nor is he subject to their interference. [Citing cases.] When, however, success crowns his effort, the amount received is in behalf and for the account of the corporation. This is so because the action belongs primarily to it. The manner and method by which such success is accomplished whether by way of judgment, settlement with court approval or by stipulation of the parties, makes no substantial difference in the interest of the corporation upon distribution of the proceeds. Requiring an accounting for moneys received in a private settlement introduces no new element. It simply amounts to a logical application of a fundamental principle inherent in the representative relation. When one assumes to act for another, regardless of the manner or method used in accomplishing a successful termination, he should willingly account for his stewardship. The plaintiff-stockholder, in good conscience, should not be allowed to retain the proceeds of a derivative suit discontinued by stipulation, to his individual use, in opposition to the corporation, any more than the proceeds of a judgment or a settlement with court approval.

The complaint, we believe, states a cause of action.

The judgments should be reversed and the motion to dismiss the complaint denied, with costs in all courts.

MAY v. MIDWEST REFINING COMPANY et al.

Circuit Court of Appeals of the United States, First Circuit, 1941. 121 F.2d 431.

[This is a suit in equity brought by a minority stockholder. Plaintiff owned 50 shares in the Midwest Refining Company, a Maine corporation, owned and controlled by Standard Oil Company of Indiana, who held 99.96% of all its outstanding shares. In 1932, at a stockholders meeting of Midwest all but 102 shares, of which 50 were owned by plaintiff, voted to sell its properties and assets to Standard Oil and Stanolind Oil and Gas Company, a Delaware subsidiary of Standard Oil. The conveyances were made and shortly thereafter plaintiff filed his bill for rescission and an accounting on the ground that Standard Oil, as majority stockholder of Midwest, was its trustee,

rendering the sale void under Maine law, which prohibits a trustee from buying property he holds in trust. In answer to plaintiff's demand for relief, defendant Standard Oil filed a special motion, which stated: it had bought all but 62 of the 102 shares voting against the sale; of these 62 shares, 12 were owned by a stockholder who had his stock valued under the Maine valuation statute; since plaintiff failed to comply with that statute he is not entitled to have the sale set aside; his interest amounts to $80.12 for each million dollars which might be found due under plaintiff's bill. Therefore, as he is the sole stockholder seeking any relief, they offer to pay plaintiff his full share of any amounts he might recover under his bill plus costs and counsel fees. The District Court granted defendants' motion and plaintiff appeals on the ground that he is entitled to have the sale rescinded because (a) it was void, (b) it was in breach of trust.]

WOODBURY, CIRCUIT JUDGE. * * * We come now to a consideration of the plaintiff's allegations with respect to the transactions of the Standard Oil Company with the Midwest Refining Company before the sale of the latter's property and assets. The defendants contend that they are entitled to have the plaintiff's bill dismissed upon payment to him in money of all that he personally would be able to recover in the event that in a trial upon the merits he should succeed in establishing all of the above allegations of his bill. The amount of his maximum possible recovery under these allegations has been agreed upon, and that sum has been paid into court for his benefit. The plaintiff takes the position that, since suits of this sort are in behalf of or in the right of the corporation, relief or payment should not run to him personally but to the corporation so that he and all other stockholders similarly situated may share therein derivatively.

While it is true that the plaintiff's suit is derivative, and while it is true that it is also representative in that other stockholders similarly situated are entitled to share in the proceeds thereof, (for this reason relief in suits of this sort ordinarily, although not universally (Joyce v. Congdon, 114 Wash. 239, 195 P. 29; 41 Col. Law Rev., 405, 416 and cases cited in footnote 78), runs to the corporation in whose behalf suit is brought) it is also true "that *every* suit in a derivative capacity *necessarily* includes a suit in an individual capacity as well." Col. Law Rev., supra. Thus the plaintiff is acting a dual role. He is suing on behalf of his corporation to redress a wrong allegedly done to it, and he is also suing on his own right as a stockholder to redress a wrong which he alleges that he, himself, has sustained by reason of his stock ownership. In the latter role he "may continue, compromise, abandon or discontinue it (the suit) at his pleasure until a stockholder similarly situated has procured an order to be made a party". 3 Cook on Corporations, 8th Ed., § 748, cited with approval in Johnson v. King-Richardson Co., 1 Cir., 36 F.2d 675, 67 A.L.R. 1465. See also, 41 Col. Law Rev., supra. But no other stockholder has sought to intervene, if there are any still in a position to do so, and thus the plaintiff's control over the litigation remains unimpaired and he can still at any time he wishes settle the case and dismiss his bill. In view of this and of the fact that, as appears above, equitable relief is inappropriate, we

see no reason why the plaintiff's bill should not be ordered dismissed upon a voluntary payment to him in money of all the damages which he admits that he could possibly recover under the allegations contained therein. In short, from the plaintiff's power to dismiss his suit at will, follows the power of the court under the circumstances of this particular case, to decree a dismissal of the plaintiff's bill upon payment in full of all of his individual damages.[1] * * *

KEENAN v. ESHLEMAN et al.

Supreme Court of Delaware, 1938. 23 Del.Ch. 234, 2 A.2d 904.

LAYTON, CHIEF JUSTICE. * * * Finally the appellants contend that the recovery decreed by the Court below should have been limited to those stockholders who had not acquiesced in, ratified, approved and confirmed the wrongful acts complained of. The question was first suggested by the Chancellor in his opinion reported in Del.Ch., 187 A. 25: whether ratification by a majority of the stockholders, while not sufficient to bar a remedy to the minority, may yet be shown for the purpose of confining the relief of the decree to the dissentients only. In his opinion reported in Del.Ch., 194 A. 40, the question was posed as follows [page 42]: "should the defendants pay to the corporation the full amount of restitution, or should they only pay to the complainants individually the pro rata amount of the recoverable sum which the proportion of their shares bears to the total number of shares outstanding?" He observed that the bill was filed on behalf of the corporation; that the relief sought was in redress of a wrong to the corporation; and that if the recoverable amount should be reduced to a sum sufficient to recompense only the dissentient stockholders and should be decreed to be paid to those of them asserting their claim, the suit would be transformed by the decree to one seeking an individual redress from one asserting a corporate claim; that the only theory upon which this case could be justified was that as the corporation's claim against the officers was a part of its assets, and that as the assets were derivatively the property of the stockholders, it must follow that if the complainants and others in like situations should be paid this aliquot part of the recovery, they would be fully compensated; that this view treats the recovery as an asset available for dividends immediately to be distributed; and that as some of the stockholders had by their votes waived their rights to their share of the dividends, payment should be decreed only to the dissenting stockholders. After reviewing the cases, the court below disapproved entirely of the theory of such decree in the circumstances presented, and ordered restitution in full to be made to the corporation. The appellants assign this as error, and urge that, within the principles of remedial equity, adequate redress of the wrong would be accomplished by a decree awarding to the dissentients an aliquot part of the re-

1 Cert. den. 314 U.S. 668, 62 S.Ct. 129 (1941).

covery; and they offer certain authorities in support of their contention. * * *

The question is whether ratification of fraudulent acts by a majority of the stockholders enures to the benefit of the defendants to the extent that the decree against them should be in such amount as to redress the wrong suffered by the dissenting stockholders by causing to be paid to them a dividend of the recoverable amount measured by their stock holdings. The answer must be in the negative. In the first place, it does not appear that the financial position of the company was such as to permit the disbursement of the recoverable amount as a dividend. The misappropriations were a fraud on Sanitary, acts which the directors could not have authorized, and which the stockholders could not ratify. To allow the defendants to retain a part of the misappropriations in proportion to the stock interest of the ratifying stockholders would be to permit ratification of illegal acts to that extent. In the circumstances it was ultra vires the corporation, its directors and stockholders, to make donations of corporate assets. In effect, to allow the defendants to retain a part of their unlawful gains would constitute a gift. The action here was a derivative one, brought on behalf of the corporation, and the complaint and the defenses are to be considered as though the corporation itself were suing the defendants. If such were the action, releases to the individual defendants by one or more stockholders would be without legal effect, and in a derivative suit, such as this, releases, ratifications or waivers are equally ineffective. To permit the recovery to be diminished by an amount in proportion to the stock holdings of the ratifying stockholders would tend to encourage fraud; the effect would be to transform, by molding the decree, a derivative action into one for the benefit of the individual; and would not accord with the theory of the complaint, the prayer for relief, or the inherent nature of the wrong sought to be redressed. It would tend to weaken, if not to destroy, the efficacy of a stockholder's action to correct a corporate wrong; and would compel the complaining stockholder to accept that for which he had not sued.

It is true that the benefit of an action brought by a corporation, or a derivative action on its behalf, necessarily results to all of the shareholders equally, even when some of them have been wrongdoers, or have by acquiescence, or ratification, forfeited their equitable claims to redress; but the best method to work out the rights of the parties in a case of this kind is to preserve the fiction of corporate entity. If the misappropriation is to be regarded as a fund for a dividend in which the dissenting stockholders are to share, the result is a subterfuge, and in most cases, violative of equity. It is an old saying that one should be just before being generous, and this common sense truth is especially applicable to stockholders who, for one reason or another, are willing to condone a wrong done to their corporation and themselves. They cannot be generous with the corporation's money. They, of course, may be as generous as they please when the money has become their own.

While there may be exceptional cases, as for example, Bailey v. Jacobs, supra, and Matthews v. Headley Chocolate Co., supra, where

remedial equity is satisfied by allowing a recovery in an amount sufficient to satisfy non-assenting stockholders measured by their stock holdings, we are of opinion that, generally, where the action is a derivative one, brought for the benefit of a going corporation, equitable principles demand that the theory of the action be recognized and that the whole recoverable amount be decreed to be paid to the corporation, notwithstanding releases, ratifications or waivers after the event.

The decree of the Court below entered on July 14, 1937, is sustained.

KARASIK v. PACIFIC EASTERN CORPORATION (SACHS et al, INTERVENORS).

Court of Chancery of Delaware, 1935. 21 Del.Ch. 81, 180 A. 604.

Bill by Tillie Karasik against the Pacific Eastern Corporation, formerly known as the Goldman Sachs Trading Corporation, in which Walter E. Sachs and others, executors of the estate of Harry Sachs, deceased, and others intervened, for an injunction restraining the settlement of certain suits. On exceptions to the report of a special master to whom the cause was referred.

Bill dismissed.

THE CHANCELLOR. * * * All the suits which the settlements propose to compromise involve the same subject matter. They are suits filed by stockholders of a Delaware corporation formerly known as The Goldman Sachs Trading Corporation and now known by the name of Pacific Eastern Corporation (herein called Pacific Eastern). The suits may be referred to as the "primary suits." The defendants in those suits are the officers and directors of Pacific Eastern, the members of a partnership called Goldman Sachs and Company, a firm of bankers and investment bankers which had a management contract with the corporation, and certain other individuals. The primary suits were filed by the complaining stockholders in their derivative right, and the bills asserted a ground of action for large damages in behalf of the defendant company. The gist of the complaint in each case was that the individual defendants and the partnership had so managed the assets of the corporation that the same were wilfully and recklessly squandered and wasted in the amount of many millions of dollars, for which an accounting to the corporation was prayed. * * *

While the primary suits were pending, negotiations for settlement were opened. On August 8, 1933, the defendants in the primary suits, all except Jonas, arrived at a basis of compromise with the directors of Pacific Eastern. Only one of the defendants, Walter Sachs, was a director when the settlements were negotiated. He took no part in them on the corporation's side. Jonas was left out of the settlement of August 8, 1933. He had before him the prospect of remaining the sole defendant. He felt aggrieved that he should have been thus abandoned and left to defend the suits alone, especially since he had had far less contact with the matters charged as grievances in the primary suits than his settling co-defendants had had. Jonas expressed his resentment. Certain remarks of Judge Hofstadter in one

of the suits in the Supreme Court of New York fortified his feeling that his resentment was justified. Negotiations were opened with Jonas on about August 10, 1933. He made a final offer of settlement on August 24, 1933, solely, it appears, as a peace-buying proposition. On the next day, viz., August 25, 1933, the directors considered the Jonas offer and resolved upon its acceptance.

The offers of settlement were submitted to the stockholders of Pacific Eastern for approval or rejection. While there was no legal requirement that the stockholders should be called upon to express their desires in the matter, yet the directors, acting upon the advice of their attorney, deemed it best, under all the circumstances, that the stockholders should pronounce the final word of approval or disapproval. There were 5,765,081 shares of Pacific Eastern outstanding and entitled to vote. Of these shares 3,691,963 were present at the stockholders' meeting. Of the shares which voted 3,041,517 voted in favor of the settlements and 10,178 voted in opposition thereto. Stock held by the defendants in the primary suits did not vote.

The compromises thus arrived at involve the granting of general releases to the defendants in the primary suits. The settlement reached with the defendants other than Jonas provides for the receipt by Pacific Eastern of one hundred thousand shares of its stock and eighty-five thousand dollars in cash, which, allowing three dollars per share as the market value of the stock, makes the equivalent of three hundred and eighty-five thousand dollars. Of this amount Pacific Eastern would receive a net of not less than two hundred and ten thousand dollars, the balance going for costs and fees. From the Jonas settlement, Pacific Eastern will receive forty thousand dollars net. The total of net yield to Pacific Eastern, if the settlements go through, will therefore be two hundred and fifty thousand dollars. If book-value of the stock be the measure of its worth, the net to the corporation would be four hundred and fifty thousand dollars. The gross would be three hundred and eighty-five thousand dollars or five hundred and eighty-five thousand dollars, according as the stock is appraised at market value or book value.

It is these settlements in compromise of pending litigation which the pending bill seeks to enjoin.

The solicitors for the complainant take the view that the transfer to the corporation of one hundred thousand shares of its own stock yields nothing to the corporation. Both before the master and in their argument at the bar and on their briefs, they rather derided the suggestion that the corporation in receiving one hundred thousand shares of its own stock, gained anything. Their view is that all that the ownership of the shares results in is a reducing of outstanding capital liability. This, they say, gives the corporation nothing. They are plainly in error—so plainly so that if it were not for their tenacious insistence upon the contention, I would not deem it a point meriting an answer. The answer is that the stock when acquired becomes treasury stock which may be sold by the corporation and realized upon as any other asset; or, if it is desired not to sell the stock, its retention by the corporation increases pro tanto the asset value underneath the stock held by the general body of the stockholders who are

in a material though not technical sense the corporation, so to speak.

The bill attacks the settlements as fraudulent. It charges first that the amount of the claim for which a decree can be secured in any one of the primary suits is as much as one hundred million dollars, and that any settlement which yields to the corporation a net of only two hundred and fifty thousand dollars (or even four hundred and fifty thousand dollars) is so grossly inadequate as to be a fraud on dissenting stockholders. It charges next that the directors and dominant stockholders of Pacific Eastern in approving of the settlement were under the control and domination of the defendants in the primary suits or some of them. The answers deny that the settlement is an improvident one and deny that the action of the directors and stockholders of Pacific Eastern was in any wise induced or controlled by the defendants in the primary suits or any of them. The answers insist that under all the circumstances the settlements were in the best interests of the Pacific Eastern Corporation and that the directors and stockholders were actuated by good faith in approving of them.

That a great disparity in value between what a corporation receives in exchange for what it gives up, may be a prima facie badge of fraud on the dissenting minority was held in Allied Chemical & Dye Corp. v. Steel & Tube Co., of America, 14 Del.Ch. 1, 120 A. 486. This principle is relied on by the complainant here. If, however, the disparity notwithstanding its magnitude is consistent with honesty of intent in accepting it, the appearance of fraud is removed. There is a presumption, rebuttable of course, that the directors of a corporation are actuated in their conduct of the business of the corporation by a bona fide regard for the interests of the corporation. Mercantile Trading Corp. v. Rosenbaum Grain Corp., 17 Del.Ch. 325, 154 A. 457; Davis v. Louisville Gas & Electric Co., 16 Del.Ch. 157, 142 A. 654; Finch v. Warrior Cement Corp., 16 Del.Ch. 44, 141 A. 54; Robinson v. Pittsburgh Oil Refining Corp., 14 Del.Ch. 193, 126 A. 46. An honest mistake of business judgment on the part of directors is not reviewable by courts. This is the general rule and it is supported by the decision of the Supreme Court of this State in Bodell v. General Gas & Electric Corp., 15 Del.Ch. 420, 140 A. 264.

The master found, after a careful and what appears to me to be an exceedingly intelligent review of the testimony and the arguments based thereon, that the decision of the directors and stockholders to accept the settlements was arrived at in the light of what seemed to them an adequately full investigation and in the exercise of their honest business judgment that the best interests of the corporation would be served by making the settlements. He has summarized his conclusions as follows:

"(1) The adverse interest in a director voting upon a corporate matter, which will vitiate the action of his corporation therein, is a direct adverse personal interest in the transaction itself and not an incidental or collateral personal interest, which may be subserved, or advantage, which may be gained, by reason of the effect of the contract or other transaction upon matters not directly connected therewith.

"(2) That, even taking as true the allegations in complainant's brief, the alleged 'dual positions and inconsistent relationships' of the di-

rectors of Pacific Eastern Corp., who voted to accept the proposed settlement, were not such as to create in them a legally recognizable 'adverse interest'; that the personal interests to be subserved and the personal advantages to be gained, if any, were purely incidental and collateral, 'wholly unconnected with the contract before the board,' and that the agreement of settlement, authorized by them, was not thereby rendered voidable.

"(3) That Guggenheimer's employment, as attorney for Pacific Eastern Corp. in the settlement, did not legally vitiate the settlement, nor cast any doubt on its bona fides.

"(4) That the value of the consideration to be received in settlement was $385,000. (unless it be taken at 'asset value' $585,000.) and the probably realizable value of the assets of the firm and the individual members thereof, under judgments in the stockholders' suits, if and when obtained, would not exceed $2,000,000.

"(5) That in any contract for the sale of a corporation's assets, or similar transaction authorized by the directors, the inadequacy of the consideration to be received by the corporation may be so great, so 'gross,' as to be a 'badge of fraud,' that is to say, such prima facie evidence of fraud on the part of the directors or on the part of the other party to the contract, or of their reckless indifference to the rights of the corporation and its stockholders, as to prompt judicial investigation to ascertain whether, in fact, it was tainted by such actual fraud or authorized in such reckless indifference; that if the evidence adduced in such investigation convincingly prove the presence in the transaction of either of these invalidating elements, a court of equity may afford appropriate relief; that a 'badge of fraud,' in its legal meaning, is a 'sign or indicium of fraud,' but does not in itself per se constitute fraud nor is it conclusive evidence of fraud.

"(6) That the right of a stockholder to have any action of the directors of a corporation set aside is dependent upon proof that such action was ultra vires or fraudulent and seriously injurious to the corporation, or that the directors acted for their own interest in a manner destructive to the interests of the corporation or the other stockholders, or that a majority of the stockholders are oppressively and illegally pursuing, in the name of the company, a course in violation of the rights of the other stockholders, which is restrainable by a court of equity.

"(7) That there is not in this settlement a 'gross inadequacy' of consideration; that the consideration is, in fact, adequate.

"(8) That, even if the consideration were found to be 'inadequate,' there is no proof of fraud on the part of the directors.

"(9) That the alleged 'mutual, material mistakes of fact, underlying the judgment of the directors in this matter (as to the value of the firm's assets and in not marshalling the unpledged assets and the unsecured liabilities in making their estimate of the amount of the firm's assets recoverable in judgments in the stockholders' suits) were neither mutual, nor material, nor mistakes and therefore cannot be held to vitiate the settlement.

"(10) That the agreement to give a general release, to the members of the firm and to R. Jonas, was a matter resting in the sound discre-

tion of the directors and that their decision must be accepted, unless the giving of such a release was ultra vires of the corporation.

"(11) That, while the giving of a general release by a corporation is a matter to be carefully considered and to be capable of justification under all the circumstances, it is not ultra vires of the corporation or its directors.

"(12) That the contention of the complainant that the votes of certain directors were invalidated, because they based them on a belief of absence of merit in the stockholders' suits, which is contrary to the 'assumption' in this reference, is fallacious.

"(13) That, while the research and inquiry, into the merits in the stockholders' suits and into the financial condition of the firm and its individual members by the directors and their attorney, were not absolutely and completely exhaustive, they were sufficiently thorough to give the directors a sufficient knowledge to enable them to decide, with all due regard to the interests of the corporation, whether the settlement offered was properly acceptable.

"(14) That the directors exercised an 'informed, independent judgment' unaffected by the advice, opinions, requests or other sorts of influence given, made or exerted by anyone, other than their legal counsel.

"(15) That the settlement was not 'improvident' in any sense that justifies the interference of the court.

"(16) That, because of the membership of W. E. Sachs, one of the defendants to be released, in the board of directors of Pacific Eastern Corporation at the time the offer of settlement was accepted, the burden of proving that the transaction was fair and just to the corporation, with respect to the adequacy of the consideration, rests on him.

"(17) That the usual presumption against fraud, with respect to the alleged collusive agreement, exists in favor of the defendants and that the burden of proof thereof is on complainant.

"(18) That the evidence in the case * * * does not prove the existence of the alleged collusive agreement, but, on the contrary, satisfies me that there was, in fact, no such agreement.

"(19) That the 'assumption' of a recoverable judgment, for a very large amount, in the stockholders' suits was merely an hypothesis intended to raise the question of the adequacy of the consideration for the settlement and was created only for its procedural effect in defining the order of proof, and that the 'burden' thus placed on the defendants, insofar as the alleged collusive agreement is concerned, was not the technical 'burden of proof,' but merely the 'burden of going forward with the evidence,' of which they were subsequently relieved by the Chancellor's direction to the complainant to 'go forward' with her proof.

"(20) That where a compromise, settlement and release of any claim in litigation, actually and sincerely contested by the other party (especially when the claim is for unliquidated damages) is made by a corporation's directors, acting honestly, in bona fides, without fraud, without vitiation by reason of legally recognizable adverse interest of the directors, without reckless or careless indifference to the rights of the corporation or its stockholders, neither inadequacy of consid-

eration, or mistake of judgment, nor mistake of fact (except 'mutual mistake' as recognized by the courts), will avail as a ground for its avoidance at the suit of a stockholder and that, in such case, the courts will not inquire into the merits of the controversy so settled, nor attempt to set up their own judgment as to the propriety of such settlement, its adequacy, or the validity of the judgment of the directors in acting thereon.

"(21) That the action of the stockholders, taken at the meeting of September 25–26, 1933, effectually established the validity of the agreement of settlement, if such establishment was necessary.

"(22) My further and final conclusion is that, the contract of settlement having been ratified by an overwhelming majority of the stockholders, all questions of inconsistent relationships of the directors and their counsel, disparity, improvidence and other alleged objectionable features have been completely answered and removed from further contention and that, no fraud having been found in the directors' consideration and acceptance of the offer of settlement and no collusive agreement between Atlas Corporation and the firm of Goldman, Sachs & Co. having been proven, but rather disproven, the action of the stockholders is final and conclusive. Wherefore, I recommend that the bill be dismissed as to all parties defendant, with costs on complainant."

The complainant has filed thirty-five exceptions to the report, which in substance amount to an exception to every one of the master's findings as above set out. One or two matters are excepted to by the complainant which are not apparent from the quoted findings and which will be presently noticed. The defendants excepted to the finding above designated as (16). It is unnecessary, however, to notice that exception, because as the recommendation that the bill be dismissed will be accepted, the question raised by the sixteenth finding, so far as the excepting defendants are concerned, becomes moot.

In adopting the recommendation of the master, I conceive it to be unnecessary to review the evidence. To do so, would serve no useful purpose. It is sufficient for me to say that the master's treatment of the evidence and the views he has expressed upon the reasonable interpretation and legal effect thereof, on the whole appeal to me as sound. If at any point I should be in disagreement with the master, it would be with respect to matters which can have no effect upon the result.

There is one point in the line of the master's reasoning which the solicitors for the complainant assail with considerable vigor. Its attempted confutation is so forcefully presented that justice to the complainant's argumnent requires me to take notice of it. The point has to do with the disparity between the amount claimed in the primary suits and the amount yielded by the settlements. As before stated the amount claimed is one hundred million dollars and the amount received in settlement is a minimum of three hundred and eighty-five thousand dollars. Now that is a wide disparity. But it is one thing to assert a claim and another thing to prove the claim to judgment. Furthermore, it is one thing to obtain a judgment, and quite another thing to collect it. Figures, however imposing, should not compel practical considerations to yield place to visions.

When the cause was referred to the master, it was with the understanding (except as to Jonas) that for the momentary purposes of the reference, the merits of the claims in the primary suits should not be gone into. Of course whether those suits possessed merit to the extent claimed for them, was not only a material but it was a fundamental question in the pending suit, for if they lacked the probability of a decree in a large amount, there could be no controversy over the honesty of the settlements. Now to try the matters charged in the primary suits would involve an exceedingly lengthy inquiry into some fifty or more transactions each of which would be the equivalent of a suit by itself. In order to avoid an extensive inquiry into those matters, an inquiry that would involve the expenditure of a great length of time and of much money by all the parties, it was determined agreeably to the wishes of both sides, that the hearing before the master should proceed on the assumption, for the time being, that the charges in the primary suits would, if any one of them proceeded, yield a decree for a very large sum of money, for as much, we will say, as the full amount of one hundred million dollars which was claimed. On that assumption, the master was then to proceed to inquire into the question of whether fraud could be found in settlements which yielded to the corporation only a gross for certain of three hundred and eighty-five thousand dollars.

Now in the course of that inquiry the defendants (except Jonas) took the position that even if a decree could be obtained in one of the primary suits in the large sum claimed, an amount could not be realized therefrom beyond the ability of the defendants to pay. Hence it became pertinent to inquire—how much could be realized from the assumed decree? This inquiry was directed primarily to the financial ability of the partnership of Goldman Sachs and Company and of its individual members. The directors engaged Mr. Guggenheimer, of the firm of Guggenheimer and Untermeyer of New York City, to examine and report to them upon this phase of the matter. Mr. Guggenheimer made such an examination and laid before the directors what he had found. His investigation was far from cursory. There is no reason in assailing it as unreliable. At all events it cannot be fairly said that the directors acted in bad faith in accepting and acting upon Mr. Guggenheimer's report. The evidence shows, as the master finds, that the available assets of the firm and its members, as of the settlement date, would not exceed two million dollars. There was a great amount of evidence before the master bearing on this question of available assets of the firm and its partners. It was a subject of rather searching examination. I shall not review it. The master analyzed it in his report and reached the conclusion just stated. I am in accord with his finding.

Assuming then that the available assets as of the settlement date amounted to two million dollars, the question was whether the directors were justified in accepting from the owners of present assets in that amount, the minimum sum of three hundred and eighty-five thousand dollars, or the maximum possibly of five hundred and eighty-five thousand dollars, in gross settlement.

The action of the master in admitting evidence of facts which posited the problem before the directors in that manner, is vigorously not to say violently assailed by the solicitors for the complainant. In my judgment, however, the master was entirely correct in his views touching that aspect of the case. The chief complaint against his position in that regard appears to be that it is said to amount to a complete repudiation of an obtainable decree in the sum of one hundred million dollars, an assumption upon which the master was to proceed. The master did not repudiate the assumption. It was never assumed that one hundred million dollars would or could be collected on a decree in that amount. If that had been the assumption, there would have been no occasion to inquire further into the question of fraud. The solicitors for the complainant confuse a future judgment with its future collectibility. No judgment is worth more than it can be made to yield. Many men can be found, putting an extreme case, with whom it would be wise to settle for five hundred dollars a present judgment against them for five hundred thousand dollars.

And this, if it is not the more true is not the less so, when it is said with respect to a future judgment. The master so thought and I agree with him. He took into account the fact that the assumed judgment was in futuro, that the process of trial leading up to its rendition would be long drawn out, that, because of the nature of the business of the partnership, the publicity of the trial might well destroy its worth and visit damaging financial consequences not alone upon itself but as well upon its members, and that, therefore, the present assets available to respond to a present decree might be very considerably reduced if not altogether lost when sometime in the future at the end of such a trial, a decree would be obtained. The directors took this view into consideration in forming their judgment. The master held they were justified in doing so, and I agree. * * *

When it comes to the compromise of highly controverted disputes, the field is a peculiarly appropriate one for the exercise of the honest business discretion of a corporation's duly accredited managers. Mere mistake in the manner in which they honestly act in such matters does not justify judicial interference nor the substitution of a court's opinion for theirs. If it were not so, courts would be clogged with the pure business problems of corporations concerning which individual stockholders were in disagreement with the officers and directors chosen by the majority to think and decide for the corporate creature.

Of course if the error in judgment is contaminated by fraud, collusion or other vitiating circumstance, a case arises which calls for judicial correction. The master heard considerable testimony on the question of whether any sort of vitiating circumstance corrupted the judgment of the directors and stockholders in the matter of the settlement with Jonas. He found no evidence whatever justifying the conclusion that any circumstance of that character existed. I agree entirely with his conclusion. The fact that we are for the moment assuming that there was a great disparity between what Jonas paid and the amount for which a decree could be rendered against him in the primary suits, is the only particular in which it can possibly

be said that a circumstance appears which denounces the judgment of the directors and stockholders as prima facie fraudulent. But that circumstance loses all weight when it is remembered that in the mind of the settling directors it was non-existent. There is nothing on which to justify the belief that the directors were not wholly honest in that belief. The solicitors for the complainant sought diligently for some evidence by which they hoped to raise a reasonable suggestion that somewhere under the surface of the Jonas settlement there lurked the infection of some fraudulent influence. They failed utterly to discover it. So the master concluded. I accept his finding as fully justified.

Something is sought to be made of the fees which the corporation has agreed to pay to the lawyers who represented the complaining stockholders in the primary suits as though the size of those fees has something to do with what the settling defendants ought to pay. I agree with the master in the view that the amount paid by the corporation to the lawyers who brought suits in its behalf is a matter that is irrelevant to whether the defendants are paying to the corporation enough in settlement. The question of fees is one between the corporation and its attorneys. On that question this court has held that it will not review the action of directors in agreeing to pay an attorney's fee except for fraud. Haas v. Sinaloa Exploration & Development Co., 17 Del.Ch. 334, 155 A. 4. The bill does not seek relief against the fees as fraudulently fixed. * * *

The bill will be dismissed.

YOUNG v. HIGBEE COMPANY et al.

Supreme Court of the United States, 1945. 324 U.S. 204, 65 S.Ct. 594.

Proceeding in the matter of petition by Robert R. Young against the Higbee Company and others for authority to employ counsel to compel stockholders to account to The Higbee Company, as debtor in corporate reorganization proceeding, for the difference between what stockholders received from sale of stock and of rights under appeal from decree confirming reorganization plan and the fair value of their stock, or in the alternative that stockholders be required to pay over that amount to preferred stockholders. To review a judgment of the Circuit Court of Appeals, 142 F.2d 1004, affirming a judgment dismissing the petition, the petitioner brings certiorari.

Reversed.

MR. JUSTICE BLACK delivered the opinion of the Court.

This case presents the question of the accountability of stockholders who objected to the confirmation of a plan of reorganization under the Bankruptcy Act, and abandoned their appeal for a consideration to themselves, where the basis of the appeal was that, if successful, it would benefit the entire class.

The Higbee Company, a department store with assets of more than six million dollars, filed a voluntary petition for reorganization. It had three types of stocks, common, and first and second preferred. Two of its directors, Bradley and Murphy, claimed that they had ac-

quired by purchase a junior debt against the company of $1,952,000.00. A plan for reorganization was presented under which the owners of this junior debt were to be awarded $600,000.00 in new notes and a large block of common stock. Potts and Boag, respondents here, and owners of some shares of first preferred, objected to confirmation of the plan. They contended, on several grounds, that unless the junior debt was subordinated to the preferred stock claims, the plan allotted that indebtedness too great a share in the distribution of the bankrupt's assets. When the stockholders' committee of which they were members approved the plan, Potts and Boag resigned and announced the formation of a new committee to press their objections to the junior debt allowance. Notwithstanding these objections, the Securities & Exchange Commission recommended the plan's acceptance, 8 S.E.C. 777, and the District Court confirmed it. 50 F.Supp. 114. Potts and Boag appealed from the District Court's decree confirming the plan. Although appealing as individuals, their appeal was based almost entirely on objections to allowances for the junior indebtedness which left less for distribution among all the preferred stockholders. Their appeal sought no separate individual relief for themselves; they appealed only to have the confirmation set aside. Had their appeal succeeded, the District Court would have been required to reduce the value of junior claims asserted by Bradley and Murphy, thereby increasing the value of the claims of the preferred stockholders as a class.

In this situation, Potts and Boag sold their stock and their appeal to Bradley and Murphy, claimants under the junior debt; the consideration paid was $115,000.00. The par value of this stock was $26,-000.00. Its admitted market value at the time, as the court below found, was $17,000.00. Pursuant to this contract for sale of the appeal a stipulation for dismissal was filed in the Circuit Court of Appeals. Petitioner Young, a preferred stockholder of the same class, sought to intervene and prosecute the appeal. His petition was denied and the case was dismissed without opinion. Young then, on behalf of himself and all other preferred stockholders, filed a petition in the District Court setting up these facts and praying that he be authorized to employ counsel to compel Potts and Boag to account to the debtor for the difference between what they received and the fair value of their stock, or praying in the alternative that Potts and Boag be required to pay over that amount to the preferred stockholders. After a hearing, a special master found as a fact that Potts and Boag had appealed in behalf of themselves only and had not acted as representatives of a class. The District Court approved this finding, thought it determinative of the case, and dismissed Young's petition. The Circuit Court of Appeals affirmed. 6 Cir., 142 F.2d 1004, 1005. Because considerations of substantial importance to the effective administration of corporate reorganizations are involved, we granted certiorari, 323 U.S. 689, 65 S.Ct. 71. * * * Second: It is argued that since Potts and Boag did not expressly specify that they appealed in the interest of the whole class of preferred stockholders, but appealed only in their own names, they owed no duty to any stockholders but themselves. The appeal here, however, was not from a denial of any

individual claim of Potts and Boag. Its basis was that every other preferred stockholder, as well as themselves, would be injured by confirmation. So far as the issues raised by the appeal are concerned, the rights of Potts and Boag and the other preferred stockholders were inseparable. Thus, even though their objection to confirmation contained no formal class suit allegations, the success or failure of the appeal was bound to have a substantial effect on the interests of all other preferred stockholders. The liability of one who assumes a determining position over the rights of others must turn on something more substantial than mere formal allegations in a complaint. Equity looks to the substance and not merely to the form.

Furthermore, the right of appeal granted by a statute should not be interpreted in such way as to defeat rights clearly granted in other parts of the same Act. Peck v. Jennes et al., 7 How. 612, 623, 12 L. Ed. 841. Potts and Boag appealed under Sec. 206 of the Chandler Act, which, contrary to the general bankruptcy procedure, grants any stockholder or creditor the right to be heard on all matters relating to corporate reorganizations. Courts have liberally construed this language as authorizing appeals. We are now asked to say that the privilege of appeal granted to Potts and Boag by the Act vested them with an indefeasible right to sell the privilege to the disadvantage of all other stockholders in their class. But, historically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets; to protect the creditors from one another. And the corporate reorganization statutes look to a ratable distribution of assets among classes of stockholders as well as creditors. There would be no ratable distribution of this bankrupt estate if Potts and Boag could utilize their statutory right of appeal to get for their preferred stock $7.00 for every $1.00 paid to other preferred stockholders. We are asked to say that Congress intended such a consequence, and to construe the right of a stockholder to be heard on a plan of reorganization as carrying with it the right to "sell" the very appeal which the Act grants him.

Potts and Boag, by appealing from a judgment which affected a whole class of stockholders owed an obligation to them, the full extent of which we need not now delineate. Certainly, at the very least they owed them an obligation to act in good faith. * * * The situation which enabled them to traffic in the interests of others was created by a statute passed to protect the interests of all of them. The statute neither compels them to appeal nor to prosecute an appeal already taken contrary to their own interests; it does impose upon them the duty of good faith to all other stockholders whose interests they temporarily control because they are necessarily involved in the appeal. This control of the common rights of all the preferred stockholders imposed on Potts and Boag a duty fairly to represent those common rights. This representative responsibility is emphasized by the fact that they might have been awarded compensation for their services had they succeeded in reducing the claim of the junior indebtedness to the advantage of all the preferred stockholders. Sec. 243; cf. Sec. 249. In re Keystone Realty Holding Co., 3 Cir., 117 F.2d 1003, 1006, 133 A.L.R. 1378. They cannot avail themselves of the

statutory privilege of litigating for the interest of a class and then shake off their self-assumed responsibilities to others by a simple announcement that henceforth they will trade in the rights of others for their own aggrandizement. To hold that the Chandler Act permits this, would be to say that Congress, which sought more effectively to accomplish fair and equitable treatment of investors, had by granting a right of appeal to stockholders, defeated its purpose, and had substantially modified the whole body of law imposing the most rigorous responsibilities for fair dealing upon those who represent the rights of others.

The money Potts and Boag received in excess of their own interest as stockholders was not paid for anything they owned. It came to them in settlement of litigation which if carried to a successful conclusion would have added to the value of other preferred stockholders of the common debtor. That the suit was settled and dismissed does not alter the rights of parties as to distribution of the fruits of the settlement. A distinction as to rights arising from litigation, which rests upon the difference between a judgment and a settlement of a lawsuit, under these circumstances, as in others, is "too formal to be sound." Lyeth v. Hoey, 305 U.S. 188, 195, 196, 59 S.Ct. 155, 159, 83 L.Ed. 119, 119 A.L.R. 410; Helvering v. Safe Deposit and T. Co., 316 U.S. 56, 63–67, 62 S.Ct. 925, 929, 930, 86 L.Ed. 1266, 139 A.L.R. 1513. The appeal of Potts and Boag was alleged to be for the benefit of all preferred stockholders. In the contemplation of the statute which authorized the appeal, its fruit properly belongs to all the preferred stockholders. One creditor, therefore, cannot make that fruit his own by a simple appropriation of it. Cf. Terry v. Little, 101 U.S. 216, 218, 25 L.Ed. 864.

Third: It is argued that even though the money paid in excess of the stock value does in equity and good conscience belong to the stockholders, the bankruptcy court is without power to award the relief prayed. Courts of bankruptcy are courts of equity and exercise all equitable powers unless prohibited by the Bankruptcy Act.

Nor can we sustain the contention that relief should be denied on the allegations that Young's motive in bringing the proceeding is an unworthy one. His petition sought relief for the benefit of all the stockholders. The rights of these stockholders are not to be ignored because of some motive attributable to Young.

Reversed.

(b) Procedure

DRESDNER et al. v. GOLDMAN SACHS TRADING CORPORATION et al.

Appellate Division of New York, Second Department, 1934.
240 App.Div. 242, 269 N.Y.S. 360.

Action by Anna Dresdner and another, individually and in behalf of all other stockholders of the Goldman Sachs Trading Corporation, now known as the Pacific Eastern Corporation, similarly situated, against the Goldman Sachs Trading Corporation, now known as the

Pacific Eastern Corporation, and others. From orders of Special Term dismissing the complaint (148 Misc. 541, 265 N.Y.S. 913), and from the judgment entered thereon, plaintiffs appeal.

Reversed on the law and facts with directions, and motions to dismiss denied upon condition.

DAVIS, JUSTICE. The motions by separate defendants to dismiss the the complaint under rule 107, subd. 4, Rules of Civil Practice, have been granted. The grounds of the dismissal were that there was another action pending—not literally "between the same parties for the same cause," but on the theory that the cause of action was derivative, and that basically it was the same as in a prior action, although the nominal parties plaintiff were different.

The complaint alleges, in brief, that the plaintiffs are stockholders of the defendant corporation; that the individual defendants are directors who have been and are in control of the corporation; that they have been guilty of gross mismanagement, misconduct, and wrongful acts as such directors whereby the assets of the corporation have been wasted and dissipated; that the defendants (or some of them) have profited personally by such transactions; and the purpose of the action is to recover from the alleged wrongdoers, for the benefit of the stockholders, the value of the property alleged to have been unlawfully converted and wasted. Specific acts are alleged as constituting such misconduct.

This action was commenced April 29, 1933. Prior thereto, two similar actions had been commenced by other stockholders in this state for the same general purpose; * * *

The defendants have based their motions on an absolute legal right to have the complaint dismissed, and that right was sustained at Special Term. 148 Misc. 541, 265 N.Y.S. 913. We reach a different conclusion. Counsel differ little on the legal principles that the cause of action is that of the corporation, and whatever recovery is had will belong to it; that the derivative right of a stockholder to maintain the action arises when the corporation cannot or will not commence an action to recover assets belonging to its stockholders from those who have confiscated or wasted them; and therefore a stockholder is permitted to sue and set in motion the judicial machinery to the end that the value of the property may be recovered. Continental Securities Co. v. Belmont, 206 N.Y. 7, 13, 99 N.E. 138, 51 L.R.A.,N.S., 112, Ann.Cas.1914A, 177; Civil Practice Act, § 195. The parties also agree on the principle that, when a judgment is obtained by one stockholder, it binds all other stockholders, on the principle of res judicata.

The action may be called a "class action." The jurisdiction is of ancient origin in equity—independent of remedies given by statute under somewhat similar circumstances by sections 60, 61, of the General Corporation Law. Isaac v. Marcus, 258 N.Y. 257, 263, 179 N.E. 487; Cross v. Bishop Oil Corporation, No. 1, 218 App.Div. 632, 634, 219 N.Y.S. 181; Hawes v. Oakland, 104 U.S. 450, 460, 26 L. Ed. 827; 3 Pomeroy, Equity Jurisprudence (4th Ed.) § 1095.

Courts of equity have always exercised broad powers. The fact that several parties brought separate actions for the same general

relief did not present a distressing situation. The right to consolidate suits in equity existing long before the present section 96 of the Civil Practice Act developed in the minds of the reformers of civil practice. Actions might be stayed pending the determination of other actions, and in some instances vexatious suits resulting in multiplicity might be dismissed summarily. Stewart v. Butler, 27 Misc. 708, 709, 59 N.Y.S. 573; Wells v. Bushe (Sup.) 118 N.Y.S. 486; Keeler v. King, 1 Barb. 390; Patterson v. Northern Trust Co., 286 Ill. 564, 122 N.E. 55.

The defendants do not claim that there is any controlling authority on the precise question presented here—that a suit like this must be dismissed as of right, for the reason that another similar action has been earlier brought by a different stockholder. Nor do plaintiffs cite controlling authority to the contrary. Both sides rest their claims on certain expressions in opinions of the courts which are admitted to be dicta, and on text authorities based exclusively on such dicta. See Fletcher, Cyclopedia of Corporations, vol. 13, § 5860, Permanent Ed.; 4 Cook, Corporations (8th Ed.) § 748. In Seagrist v. Reid, 171 App.Div. 755, 760, 769, 157 N.Y.S. 979 there are statements in both the prevailing and dissenting opinions to the effect that the action first brought is a bar to the second. It is said in the opinion in Goodbody v. Delaney, 80 N.J.Eq. 417, 419, 83 A. 988, 989, that "* * * it is quite possible that if such similar suit were brought in the same court with the prior suit a plea of former action pending would be sustained." This is all that industry of counsel or our own research can produce on the proposition that a complaint in the second action should be dismissed.

The dictum relied on by appellants' counsel is found in the opinion in Brinckerhoff v. Bostwick, 99 N.Y. 185, where it is said at page 194, 1 N.E. 663, 668: "The bringing of the action by the original plaintiff did not prevent the other stockholders from bringing similar actions. But the moment a judgment should be recovered in one action for the benefit of all the stockholders, the proceedings in all the others would be stayed." This statement of the rule was later quoted with apparent approval in Hirshfeld v. Fitzgerald, 157 N.Y. 166, 181, 51 N.E. 997, 46 L.R.A. 839—a representative, not a derivative, action.

There are many actions, representative in character, where the principle is applied that a suit by one will not bar a later suit by another similarly situated. It is argued by respondents that the rule is different in derivative actions, and it was so held by the learned court at Special Term. We doubt that very much distinction can be made in principle; but to limit discussion we will assume that such distinction exists. Likewise the plaintiffs claim that in this complaint new facts are alleged; but for the purposes of this appeal we will assume, as was held at Special Term, that the differences between the complaints are only in immaterial details.

The absence of direct authority on the question here presented may indicate that for a long period of years the right of any stockholder to invoke the aid of the courts in his individual action has gone unchallenged. However, stockholders in large corporations are,

as a matter of common knowledge, generally uninformed, and in a measure indifferent concerning the management of the corporation. Generally, without inquiry, they sign proxies as a matter of course so that directors and officers may be re-elected and their policies may be continued. When dividends cease and the stock becomes comparatively worthless, they may complain and grumble, but rarely will they resort to the courts for a remedy. The reason for such inertia is readily found. Stockholders are widely scattered and have no definite method of contact with each other. They usually know that the evidence is almost exclusively in the control of those who are charged with delinquency; that those same individuals are likewise in control of the funds of the corporation and may apply them in defense of their acts, whether those acts are innocent or wrongful; that in seeking a remedy the stockholder will be met with every obstacle and procedural delay that the ingenuity of skilled counsel can devise, as is illustrated in the present case; and that the litigation must entail on their part a great expense with the eventual result in doubt. So, unless a group is organized by ambitious counsel, or one or more stockholders have great courage and ample means to maintain a long-continued litigation, the stockholders remain quiescent, accepting their misfortunes as a decree of relentless fate. It is only in times of general cataclysm or great stress, like those of the present, that indignation will flare up into some decisive action. Common experience tells us that, when officers and directors of a wrecked corporation are called to account, they are not eager to go to an early trial on the merits—whatever the merits may be. There is great reluctance to furnish the evidence of their acts of management and make disclosure of books and records. The way of the inquiring stockholder is beset with difficulties and discouragements created chiefly by those whose acts are attacked. Such, in brief, is the background of the average stockholder's action as we view it.

We hesitate, therefore, to take a narrow view of the principle of another action pending whereby as an absolute right the defendants are entitled to dismissal—relegating plaintiffs, as defendants suggest, to the doubtful remedy of intervention in the existing consolidated action. Permitting a party to intervene is always a matter of judicial discretion depending on a variety of circumstances. It is easy for defendants now to suggest such a policy to plaintiffs. But the latter may be reasonably certain that, when they may attempt to intervene, they will be met with the same strong opposition they are now encountering; and if eventually they are successful, there will be the question frequently raised as to their right of any sort of control over the action brought by others, with the argument that they must remain passive on the theory that their rights will be preserved when, if ever, a judgment may be obtained. If intervention will furnish plaintiffs a proper remedy, why is such circuity necessary, when in the exercise of its equity powers the court may grant consolidation? That procedure seemed satisfactory to defendants when on their own motion the two prior actions were consolidated. The discovery of the right to dismiss seems somewhat belated.

The procedural remedy given in rule 107, subd. 4, is not new. It was taken literally from section 488, subd. 4, Code of Civil Procedure, and was theretofore contained in section 144, Code of Procedure. It was intended to apply principally to actions at law where the parties and the cause were actually or substantially the same, and not to restrict the broad powers of a court of equity in suits of this nature, as the dictum in the Brinckerhoff Case indicates. As we have already stated, the independent right of any stockholder to sue has not been directly challenged during the period of our judicial history by a motion of this nature. The wrong is common to all stockholders. The right to sue is, we think, alike common to them.

We adopt the dictum of the Brinckerhoff Case, supra, as stating the proper doctrine to be applied; and hold that defendants have no absolute right to a dismissal. We speak of an absolute right in contradistinction to a right based on judicial discretion. The rights of defendants, if there be consolidation instead of dismissal, will not be impaired or be subject to any substantial prejudice, except as to a possible delay in the trial. They have not urged that they are eager for an early trial; in fact, everything indicates that they have no anxiety or zeal in favor of it.

The evident purpose of the plaintiffs, whether they proceed by an independent action or as parties to the one consolidated, is that they may have some control over the litigation, and thus be present on any trial to protect and secure their rights and prevent a discontinuance of the action by the original plaintiffs. Brinckerhoff v. Bostwick, supra, page 195 of 99 N.Y., 1 N.E. 663. This is a highly legitimate purpose. There is nothing to prevent the defendants, before judgment, from buying their peace with the plaintiffs in the consolidated action by means of a private settlement (Brinckerhoff v. Bostwick, supra, page 194 of 99 N.Y., 1 N.E. 663; Handford v. Storie, 2 Simons & Stuart, 196, 198), leaving other stockholders to seek their remedy by a new action, if the statute of limitations has not run against them.

Speaking generally, and not in relation to this particular case, the first action brought by a stockholder furnishes no adequate security that other stockholders will be assured of a complete remedy. The one first in the field of action may not be possessed of all the facts. He may omit from his complaint material allegations of facts which have been discovered by another more vigilant and industrious. His efforts may be thwarted by lack of funds, courage, or determination, or lack of skill and initiative on the part of his counsel. There is always, as we have said, the strong possibility of a private settlement. There is no requirement that the stockholder who sues or the defendants shall give notice of the suit to other stockholders. It is left to chance for the latter to discover it. If in good faith other stockholders are unaware of the prior action and after much expense bring an action of their own, it is a harsh and drastic doctrine which compels dismissal solely on a rule of chronology, regardless of merit. There is little fundamental virtue in such a rule.

Beyond all that, the door is open to collusive actions. It would be very easy for offending officers and directors to obtain a friendly stockholder to begin an action and to suppress all information on the subject. The defendants and not stockholders would then be in control of the litigation. If the doctrine here advocated by the defendants prevails, all other stockholders are prevented from bringing actions in good faith, unless to their already great difficulties, to which we have referred, they must have added the duty of establishing by proof that the first action is in fact collusive. If other stockholders without intervention rely on the first action to furnish a remedy to all, then it may be permitted to drag along until the statute of limitations has run and be discontinued on a private settlement or otherwise; and other stockholders will be left remediless. There should be some measure of certainty that the original action will be prosecuted to judgment, or at least that all diligent stockholders will share in a settlement, before a second action is stayed or dismissed in the exercise of judicial discretion.

Stockholders' actions (not collusive) may be brought for three distinct purposes: (1) For the genuine purpose of benefit to all stockholders with a determination to pursue the suit to judgment, with all stockholders invited in good faith to join in labor and expense; (2) for the purpose of individual benefit by private settlement, with the fact of the bringing of the suit kept secret; (3) a suit brought purely for "strike" purposes. We are concerned chiefly with the one denominated 2.

Still speaking generally, parties and counsel may not apply the same degree of skill, diligence, and good faith to the prosecution of an action. If it be left to the one who by the sheer rule of chronology is the only one entitled to prosecute, then the other stockholders who have had the temerity to sue may be left comparatively without remedy. The judgment, when obtained, is a bar to other actions, no matter what the result may be. Further than that, it is a bar not only as to the questions decided but as to those which might have been presented and tried, but were not. Cromwell v. County of Sac, 94 U.S. 351, 352, 24 L.Ed. 195; Hull v. Hull, 225 N.Y. 342, 353, 354, 122 N.E. 252. That rule is necessary in order to have a finality to litigation. No one doubts that it often results in injustice to individuals. We think that, before judgment, courts should not be eager to prevent presentation of all issues by parties sufficiently interested to begin suit, but should pursue a liberal policy in permitting them freely to participate in the trial, where the judgment will eventually become binding upon them. They should not be barred or their way made difficult by a narrow interpretation of the rule of another action pending.

The defendants argue that the plaintiffs here have not shown that there was any collusion, lack of skill or good faith, or a proposed private settlement. We have practically no information about it one way or the other. It is not necessary, for, as we have said, the defendants have moved for dismissal as an absolute right. We are attempting to formulate a rule that may apply to any case in the future, and are discussing a general principle in the light of pos-

sibilities. We believe there is not much virtue in the claim that the one who first brings suit is by that fact alone in such an advantageous position that all others must give way, regardless of the purposes of the one first on the field, his relations with the defendants, and the skill he brings to the conduct of the suit, ostensibly for the benefit of all others entitled to relief. If the first action is free from collusion and is being prosecuted with skill and in good faith, grounds for a stay of prosecution of the second action may be shown, but not, as we believe, for dismissal.

There is little danger to be apprehended here from a multiplicity of actions by all or many stockholders ranging from 25,000 to 40,000 in number. It is likely that most of them will remain inert. When such trouble actually impends, the defendants will not be unduly harassed, for the remedy by stay or consolidation is simple; and those suits purely vexatious may be summarily dismissed, on grounds, however, more substantial than mere chronology. What is sought by all stockholders acting in good faith is a prompt and efficient determination of their rights. The defendants ought not to be concerned in the question of which particular group of stockholders are engaged in the prosecution if they have meritorious defenses, particularly if all are compelled to unite, and when the judgment obtained will be conclusive on all. An excessive zeal on the part of the defendants to hinder and impede a stockholder in good faith seeking a remedy may promote a suspicion that they have a distaste for a too vigorous prosecution.

We have not in this case reached a stopping point where actions may be discouraged because of multiplicity. We think that they should not run independently, but the parties in all should unite by consolidation. There has been no motion by either side for such a remedy, so we may not order consolidation, but we may make that result simple.

There are recent conflicting decisions at Special Term on the question here presented, and therefore we have been impelled to give our views more at length than ordinarily would be required.

The orders dismissing the complaint and the judgment entered thereon should be reversed on the law and the facts, with costs, and motions denied, with $10 costs on each motion, on condition that plaintiffs offer to stipulate, within ten days after the entry of the order herein, that without formal motion an order may be entered consolidating this action with the prior consolidated actions by stockholders. If such stipulation is given, the defendants have leave to answer within ten days thereafter, or at their option to give notice to plaintiffs that they elect to let their answers in the consolidated action stand as their answers to this complaint, with leave to plaintiffs to move at Special Term for further amplification of the answers as they may be advised; otherwise the orders and judgment should be affirmed, with costs, in the exercise of discretion and not as a strict legal right.

Orders dismissing complaint and judgment entered thereon reversed on the law and the facts, with costs, and motions denied, with $10 costs on each motion, on condition that plaintiffs offer to stip-

ulate, within ten days after the entry of the order herein, that without formal motion an order may be entered consolidating this action with the prior consolidated actions by stockholders. If such stipulation is given, the defendants have leave to answer within ten days thereafter, or at their option to give notice to plaintiffs that they elect to let their answers in the consolidated action stand as their answers to this complaint, with leave to plaintiffs to move at Special Term for further amplification of the answers as they may be advised; otherwise the orders and judgment are unanimously affirmed, with costs, in the exercise of discretion and not as a strict legal right. All concur.

(c) *Attorney's Fees*

MURPHY v. NORTH AMERICAN LIGHT & POWER CO. et al.

WALTERS et al. v. SAME.

District Court of the United States, S. D. New York, 1940. 33 F.Supp. 567.

Actions by John H. Murphy, on behalf of himself and all other preferred stockholders of the North American Light & Power Company, and by John W. Walters and another, on behalf of themselves, all other such stockholders, and such company, against it and the North American Company to compel the last-named defendant, in compliance with its contract obligations to the Power Company, to surrender notes for funds advanced by it to the power company, accept in lieu thereof shares of the power company's common stock, refund interest received on the notes to the power company, and cancel claims for unpaid accrued interest thereon.

On application by William M. Dederick and Lawrence R. Condon, complainants' attorneys, for allowances of fees after decrees for complainants, 24 F.Supp. 471, were modified by the Circuit Court of Appeals, 106 F.2d 82.

Orders fixing total allowances to applicants at $200,000, to be divided equally between them, and directing defendant power company to pay each applicant $100,000.

WOOLSEY, DISTRICT JUDGE. * * * In all derivative causes like these, it must be remembered that there is not any contractual relationship whatever as to legal services except between the complainant who commences the litigation and his attorneys.

As to any other stockholders, whether common or preferred, the attorneys for the named plaintiffs are pure volunteers and any allowances for fees to which they may be entitled must be estimated principally in the light of the benefit conferred on the corporation and so, by hypothesis, on the other stockholders of all classes, by the activities of counsel on behalf of the stockholders who brought the derivative suit.

As I have stated above, in my opinion the measure of present actual benefit to the Power Company under a most generous method of valu-

ing the results of these causes can be fixed in round figures at $900,000.

This, it will be noted, is less than the amount being asked by the two attorneys for the two sets of plaintiffs.

In approaching the determination of fees properly to be allowed in these causes, one must, as a practical matter, lump the services of attorneys for both complainants together and then see how total appropriate fee thus fixed for those services should be allocated between them. Cf. In re Osofsky, D.C.N.Y., 50 F.2d 925, 926. * * *

PART VII

SALE, MERGER, CONSOLIDATION AND DISSOLUTION

A. SALE

NEW YORK STOCK CORPORATION LAW

§ 20. *Voluntary sale of franchise and property and rights of objecting stockholders.* A stock corporation, except a railroad corporation and except as otherwise provided by law, with the consent of the holders of record of two-thirds of its outstanding shares entitled to vote thereon may sell and convey its property, rights, privileges and franchises, or any interest therein or any part thereof; but franchises within the state may be sold only to a domestic corporation. Before such sale or conveyance shall be made such consent shall be obtained at a meeting of the stockholders called pursuant to section forty-five. Any stockholder not voting in favor of such proposed sale and conveyance may at any time prior to the vote thereon—or if notice of the meeting was not mailed to him at least twenty days prior to the taking of such vote, then within twenty days after the mailing of such notice—object to such sale and conveyance and demand payment for his stock, and thereupon such stockholder or the corporation shall have the right, subject to the conditions and provisions of section twenty-one, to have such stock appraised and paid for as provided in said section. Such objection and demand must be in writing and filed with the corporation.

§ 22. *New corporation may be formed under same name.* Whenever pursuant to section twenty any domestic stock corporation, except a railroad or a moneyed corporation, shall desire to sell and convey its property, rights, privileges and franchises, or any interest therein or any part thereof to a new domestic corporation, the latter may be organized under the same name, provided that:

1. There shall have been included in the stockholders' consent express consent that the good will and right to use the corporate name be sold, that a new domestic corporation be organized with the same name to acquire the property, rights, privileges and franchises, or any interest therein or any part thereof, and the good will and name of such existing corporation, and that such existing corporation be dissolved upon the expiration of the period of fifteen days from the filing of the certificate of incorporation of such new corporation in the proper state office.

2. There shall be annexed to the certificate of incorporation of the new corporation, an affidavit by the president or a vice-president and the secretary or an assistant secretary of the existing corporation stating that the consent of stockholders required by the foregoing subdivision of this section has been duly given.

3. There shall be included in the certificate of incorporation of the new corporation a statement that it is organized to acquire the property, rights, privileges and franchises, or an interest therein or a part thereof, and the good will and name of an existing domestic corporation and a statement of the date of filing of the certificate of incorporation of such existing corporation, the state office where filed, or the special law under which it is organized.

4. The consent of the department of taxation and finance to the filing of such certificate shall be indorsed thereon.

Upon the expiration of the period of fifteen days from the filing of the certificate of incorporation of the new corporation in the proper state office the old corporation shall be deemed dissolved. Its directors shall proceed to settle its affairs pursuant to the provisions of section twenty-nine of the general corporation law and of subdivisions eight and nine of section one hundred and five and of section one hundred and six of this chapter.

DELAWARE GENERAL CORPORATION LAW

Sec. 65. *Sale of Assets and Franchises:*—Every corporation organized under the provisions of this Chapter, may at any meeting of its Board of Directors, sell, lease or exchange all of its property and assets, including its good will and its corporate franchises, upon such terms and conditions and for such consideration, which may be in whole or in part shares of stock in, and/or other securities of, any other corporation or corporations, as its Board of Directors shall deem expedient and for the best interests of the corporation, when and as authorized by the affirmative vote of the holders of a majority of the stock issued and outstanding having voting power given at a stockholders' meeting duly called for that purpose, or when authorized by the written consent of the holders of a majority of the voting stock issued and outstanding, provided, however, that the Certificate of Incorporation may require the vote or written consent of the holders of a larger proportion of the stock issued and outstanding.

Sec. 66. *Sale of Franchise; Organization of Corporation to Continue:*—If the franchise and property of any corporation formed under the provision of this Chapter, or existing under the laws of this State, is sold, the persons who may become the purchasers, at private sale or under the judgment of the Court, may organize a corporation for the continuation, operation and management of the same; and such corporation, when organized shall have the same rights, privileges and franchises as have been granted to or acquired by the corporation purchased; and shall be subject to all the limitations, restrictions and liabilities imposed upon it, and, in addition thereto, shall be subject to all the provisions of this Chapter. Such corporation shall be formed by Articles of Incorporation executed by the purchaser and his associates, and which shall, in addition to the requirements of the provisions of this Chapter, set forth the description of the property sold and the decree under which the sale was made, if it was sold under judgment, or if not, the deed conveying the property; the amount paid or to be paid, and to whom and by whom, and such other state-

ments as may be deemed necessary. The articles shall be signed by the purchaser and his associates, if any, and shall be filed in the office of the Secretary of State, who shall furnish a certified copy of the same under his hand and seal of office, which shall be recorded as hereinbefore provided for certificates of incorporation; and when a certificate of such fact is delivered to the purchaser the corporation shall be deemed to be organized, and shall have all the rights, powers and privileges, and be subject to all restrictions, limitations and liabilities of other similar corporations organized under this Chapter.

TELLER et al. v. W. A. GRISWOLD CO. et al.

Circuit Court of Appeals of the United States, Sixth Circuit, 1937. 87 F.2d 603.

Suit by Jacob Teller and others against the W. A. Griswold Company and others. Decree for defendants, and plaintiffs appeal. Affirmed.

ALLEN, CIRCUIT JUDGE. Appeal by minority stockholders from a decree dismissing a bill in equity praying for receivership, and for a decree setting aside a sale of the assets and surrender of the charter of the W. A. Griswold Company, a Tennessee corporation, and for a retransfer of the assets. Appellants contend (1) that sufficient corporate action authorizing the transfer is lacking, and (2) that the transfer was fraudulent.

At a special meeting of stockholders held on April 10, 1933, a resolution was passed directing the officers and directors of the corporation to sell and convey all of the corporate assets. At that time the corporation owed about \$148,000 to the American National Bank of Nashville, \$53,000 to Tennessee Enamel Manufacturing Company, and in addition other debts amounting to several thousand dollars, including two years' taxes. There was also outstanding \$100,000 of preferred stock on which dividends amounting to \$12,000 were in default. As found by the court, the corporation was hopelessly insolvent. The assets were transferred to a new corporation organized for the purpose by the two principal creditors, who held all the stock and agreed to pay all the indebtedness except those debts owing to themselves. This agreement was consummated. The resolution for transfer was passed by more than a three-fourths majority vote of the stockholders, appellants, common stockholders being the only dissenters. Appellants were not rightly entitled to vote, because under the charter and bylaws, the preferred stock had the exclusive voting power, as the dividends thereon were in default. The preferred stock was voted unanimously in favor of the resolution. No objection was raised to the voting of appellants' common stock. The directors took no action, but the president and secretary of the corporation executed the instruments transferring the assets to the new corporation.

Appellants claim that the transfer is null and void because it was not authorized by vote of the directors. They rely upon section 3748 of the Tennessee Code of 1932, which provides for the sale of corporate assets by the directors. An earlier provision of the Tennessee statutes, chapter 437 of the Acts of 1907, which is almost identical with the statute relied on here, was construed in Carrier v. Dixon, 142 Tenn.

122, 218 S.W. 395, where a similar transfer was attacked upon the ground that the directors had not acted. That case held that the statute is permissive but not mandatory upon insolvent corporations. The court at page 125 of 142 Tenn., 218 S.W. 395, says "it has never been questioned that in the case of embarrassed or insolvent concerns the will of a majority of the stockholders, when acting fairly and in good faith, is supreme, and that minority or dissenting stockholders will not be permitted to obstruct or interfere with the conduct of corporate affairs directed by the majority." This is the latest pronouncement of the Supreme Court of Tennessee upon this point, and it decides the legal question squarely in favor of appellees. It is axiomatic that we follow decisions of the highest court of the state interpreting statutes of that state. Kentucky Macaroni Co., v. London & Provincial M. & G. Ins. Co., Ltd., 83 F.2d 126 (C.C.A.6).

Knapp v. Supreme Commandery, United Order of the Golden Cross, 121 Tenn. 212, 118 S.W. 390, relied on by appellants, is inapplicable, for it dealt with a solvent corporation.

We conclude that the action by the officers which complied with the resolution adopted by the majority stockholders constituted a proper transfer. * * *

The decree is affirmed.

NOTE

When a corporation sells its business, the buyer customarily purchases on the basis of a recent audit showing the condition of the concern as of the audit date. The contract of purchase commonly includes a clause similar to the following:

"The vendor corporation represents and warrants and agrees with the purchaser that the balance sheet of the vendor as of June 30, 1947, together with the statements of income and surplus of the vendor for the six months then ended, as certified by the treasurer of the vendor and heretofore furnished to the purchaser, reflect the financial condition of the vendor subject only to changes in the ordinary course of business, since June 30, 1947. There have been no material adverse changes in the financial condition or in the assets and liabilities of the vendor and the vendor agrees with the purchaser that there will have been no such material adverse changes as of the date of closing hereinabove provided for and the vendor agrees to furnish to the purchaser a certificate of its president and treasurer at the closing to that effect."

B. MERGER AND CONSOLIDATION

NEW YORK STOCK CORPORATION LAW

§ 85. *Merger.* 1. Any domestic stock corporation or any foreign stock corporation authorized to do business in this state owning all the stock of any other domestic stock corporation, authorized to engage in business similar or incidental to the business which the possessor corporation is authorized to engage in, and any domestic stock corporation owning all the stock of any foreign stock corporation authorized to do business in this state and authorized to engage in business similar or incidental to the business which the possessor corporation is authorized to engage in, may file in the office of the secretary of state a certificate of such ownership, in its name and under its corporate seal, signed by its president or a vice-president and its secre-

tary or treasurer and setting forth a copy of the resolution of its board of directors to merge such other corporation, and to assume all of its obligations, and the date of the adoption thereof. * * * Upon the filing of such certificate, all of the estate, property, rights, privileges and franchises of such other corporation, shall vest in and be held and enjoyed by such possessor corporation as fully and entirely and without change or diminution as the same were before held and enjoyed by such other corporation, and be managed and controlled by such possessor corporation, and, except as provided in subdivision three of this section, in its name, but subject to all liabilities and obligations of such other corporation and the rights of all creditors thereof. The possessor corporation shall not thereby acquire power to engage in any business or to exercise any right, privilege or franchise of a kind which it could not lawfully engage in or exercise under the provisions of the law by or pursuant to which such possessor corporation is organized. * * *

2. The possessor corporation shall be deemed to have assumed all the liabilities and obligations of the merged corporation and shall be liable in the same manner as if it had itself incurred such liabilities and obligations.

3. If the possessor is a domestic corporation it may relinquish its corporate name and assume in place thereof the name of the merged corporation by including a provision to that effect in the resolution of merger adopted by the directors and set forth in the certificate of ownership, and upon the filing of such certificate the change of name shall be complete with the same force and effect and subject to the same conditions and consequences as if such change had been accomplished by proceedings under the general corporation law. No corporation shall change its name under this section unless the name assumed contains some word or abbreviation clearly indicating that it is a corporation.

7. In the event all of the stock of the corporation proposed to be merged by a possessor is not owned by such possessor corporation, any stockholder of the corporation so to be merged may, within twenty days after the filing of the certificate with the secretary of state, object to such merger and demand payment for his stock. Such objection and demand must be in writing and filed with the possessor corporation. Thereupon such stockholder and the possessor corporation shall have the right, subject to the conditions and provisions of section twenty-one, to have such stock appraised and paid for as provided in said section.

§ 86. *Consolidation.* Any two or more domestic business corporations may be consolidated into a single corporation, which may be either a new corporation or any one of the constituent corporations, by the filing of a certificate which shall be entitled and endorsed "Certificate of consolidation of ——— and ——— into ———, pursuant to section eighty-six of the stock corporation law" (the first blank spaces being filled in with the names of the constituent corporations and the last blank space being filled in with the name of the corporation formed by or which is to survive the consolidation) and which shall set forth:

1. The name of each corporation to be included in the consolidation, and the date of filing of its certificate of incorporation in the department of state, or, if any such corporation is created by a special law and has no certificate of incorporation, the chapter number and year of passage of such law.

2. The total number of shares which each of the corporations to be included in the consolidation is authorized to issue, the number thereof which have a par value, if any, together with the par value of each, and the number thereof which are without par value.

3. The name of the consolidated corporation, which name may be that of any of the constituent corporations or an entirely new name permitted under the provisions of section nine of the general corporation law.

4. Either the amount of the capital stock of the corporation and the number and par value of the shares of which it is to consist, or, if the corporation is to issue shares without par value, the statements required by section twelve. If the shares are to be classified, the number of shares to be included in each class and all of the designations, preferences, privileges and voting powers of the shares of each class, and the restrictions or qualifications thereof.

If any class of stock which is preferred as to dividends or assets is to be issued in series as provided by section eleven, either (a) the designations, preferences, privileges and voting powers of the shares of the first series of such class, and the restrictions or qualifications thereof, and that the board of directors is authorized to fix from time to time before issuance the designations, preferences, privileges and voting powers of the shares of each subsequent series of such class, and the restrictions or qualifications thereof, or (b) that the board of directors is authorized to fix from time to time before issuance the designations, preferences, privileges and voting powers of the shares of each series of such class, and the restrictions or qualifications thereof.

5. The city, village or town and the county, within the state, in which the office of the corporation is to be located, and the address within or without the state, to which the secretary of state shall mail a copy of process in any action or proceeding against the corporation which may be served upon him.

6. Its duration.

7. The number of its directors, or that the number of directors shall be not less than a stated minimum nor more than a stated maximum. In either case the number of directors shall be not less than three.

8. If the consolidated corporation is to be a new corporation, the names and post-office addresses of the persons who are to be its directors until the first annual meeting of its stockholders, and if such address shall be in a city, the street and number or other particular description thereof. The number of the directors so named must be the number stated pursuant to the last preceding subdivision of this section if a definite number be stated, or, if an indefinite number be provided for, not less than the minimum number.

9. The terms and conditions of the consolidation, if any; the mode of carrying the same into effect, and the manner of converting the shares of each of the constituent corporations (or, if the consolidated corporation is to be one of the constituent corporations and the outstanding shares of such surviving constituent corporation are not to be changed, the shares of each of the other constituent corporations) into shares or other securities of the consolidated corporation.

10. That the secretary of state is designated as the agent of the corporation upon whom process in any action or proceeding against it may be served.

11. If the consolidated corporation is to be one of the constituent corporations and not a new corporation, a statement to that effect, setting forth the name of such surviving constituent corporation.

In the case of a consolidation of two or more domestic business corporations, such certificate may contain such other provisions as might be included in a certificate of incorporation pursuant to article two of this chapter and such other provisions as are deemed necessary or desirable in connection with the consolidation, but in such case no such certificate may confer on the consolidated corporation any powers, rights, privileges or franchises which may not be exercised by a corporation organized pursuant to article two of this chapter or contain provisions inconsistent with the laws relating to such a corporation. * * *

Upon the filing of such certificate the certificate of incorporation or special law incorporating any constituent corporation surviving the consolidation shall be deemed amended to the extent necessary to bring such certificate of incorporation or special law into conformity with the provisions of the certificate of consolidation.

If such certificate contains a statement in conformity with paragraph (B) of subdivision four of section twelve, the amount of the consideration received by the consolidated corporation for the issuance of such of its shares without par value as are substituted upon conversion for previously issued and outstanding shares with par value of the constituent corporations, shall be deemed to be the amount of the par value of such previously issued and outstanding shares, or if the actual value of such shares be less than their par value, the consideration may be stated to be their actual value, and the amount of the consideration received by the consolidated corporation for the issuance of such of its shares without par value as are substituted upon conversion for previously issued and outstanding shares without par value of the constituent corporations shall be deemed to be the amount of the capital of the constituent corporations represented by such outstanding shares without par value for which the shares of the consolidated corporation without par value are substituted upon conversion, or if the actual value of such shares of the constituent corporations be less than the amount of the capital of the corporations represented by such shares without par value, the consideration may be stated to be their actual value.

The aggregate value of the properties, franchises and rights of the constituent corporations at the date of consolidation shall be at least equal to the liabilities of the consolidated corporation as of said date,

including its capital and the aggregate principal amount of any securities representing debt of the consolidated corporation which, under the terms of the consolidation, are substituted for previously issued and outstanding shares of the constituent corporations; and any excess in the aggregate value of such properties, franchises and rights over such liabilities as of said date may be deemed to be surplus of the consolidated corporation.

§ 88. *Powers of corporation formed by consolidation.* Such consolidated corporation in addition to the general powers of corporations shall enjoy the rights, franchises and privileges possessed by each of the corporations so consolidated, subject to the restrictions, liabilities, duties and provisions contained in this chapter, and may prosecute or carry on any kind of business which any of the consolidating corporations was authorized by law to conduct.

§ 89. *Transfer of properties of constituent corporations to corporation formed by consolidation.* Upon the filing of such certificate of consolidation in the office of the secretary of state all the rights, privileges, franchises and interests of each of the constituent corporations, and all the property, real, personal and mixed, and all the debts due on whatever account to any of them, as well as all stock subscriptions and other things in action belonging to any of them, shall be taken and deemed to be transferred to and vested in such consolidated corporation, without further act or deed; and all claims, demands, property and every other interest shall be as effectually the property of the consolidated corporation as they were of the constituent corporations, and the title to all real estate, taken by deed or otherwise, under the laws of this state, vested in any of such constituent corporations, shall not be deemed to revert or be in any way impaired by reason of the consolidation, but shall be vested in the consolidated corporation.

§ 90. *Rights of creditors of consolidated corporations.* The rights of creditors of any constituent corporation shall not in any manner be impaired, nor shall any liability or obligation due or to become due, or any claim or demand for any cause existing against any such corporation or against any stockholder thereof be released or impaired by any such consolidation; but such consolidated corporation shall be deemed to have assumed and shall be liable for all liabilities and obligations of each of the corporations consolidated in the same manner as if such consolidated corporation had itself incurred such liabilities or obligations. The stockholders of the respective constituent corporations shall continue subject to all the liabilities, claims and demands existing against them as such at or before the consolidation; and no action or proceeding then pending before any court or tribunal in which any constituent corporation is a party, or in which any such stockholder is a party, shall abate or be discontinued by reason of such consolidation, but may be prosecuted to final judgment, as though no consolidation had been entered into; or such consolidated corporation may be substituted as a party in place of any constituent corporation, by order of the court in which such action or proceeding may be pending.

DELAWARE GENERAL CORPORATION LAW

Sec. 59. Consolidation or Merger; Proceedings for:—Any two or more corporations organized under the provisions of this Chapter, or existing under the laws of this State, for the purpose of carrying on any kind of business, may consolidate or merge into a single corporation which may be any one of said constituent corporations or a new corporation to be formed by means of such consolidation or merger as shall be specified in the agreement hereinafter required; the directors, or a majority of them, of such corporations as desire to consolidate or merge, may enter into an agreement signed by them and under the corporate seals of the respective corporations, prescribing the terms and conditions of consolidation or merger, the mode of carrying the same into effect, and stating such other facts required or permitted by the provisions of this Chapter to be set out in Certificates of Incorporation, as can be stated in the case of a consolidation or merger, stated in such altered form as the circumstances of the case require, as well as the manner of converting the shares of each of the constituent corporations into shares or other securities of the corporation resulting from or surviving such consolidation or merger, with such other details and provisions as are deemed necessary.

Said agreement shall be submitted, to the stockholders of each constituent corporation, at a meeting thereof, called separately for the purpose of taking the same into consideration; of the time, place and object of which meeting due notice shall be given by publication at least once a week for four successive weeks in one or more newspapers published in the county wherein each such corporation either has its principal office or conducts its business, and a copy of such notice shall be mailed to the last known post-office address of each stockholder of each such corporation, at least twenty days prior to the date of such meeting, and at said meeting said agreement shall be considered and a vote by ballot, in person or by proxy, taken for the adoption or rejection of the same, each share entitling the holder thereof to one vote; and if the votes of stockholders of each such corporation representing two-thirds of the total number of shares of its capital stock shall be for the adoption of the said agreement, then that fact shall be certified on said agreement by the Secretary or Assistant Secretary of each such corporation, under the seal thereof; and the agreement so adopted and certified shall be signed by the President or Vice-President and Secretary or Assistant Secretary of each of such corporations under the corporate seals thereof and acknowledged by the President or Vice-President of each such corporations before any officer authorized by the laws of this State to take acknowledgments of deeds to be the respective act, deed and agreement of each of said corporations and the agreement so certified and acknowledged shall be filed in the office of the Secretary of State, and shall thence be taken and deemed to be the agreement and act of consolidation or merger of the said corporations; and a copy of said agreement and act of consolidation or merger, duly certified by the Secretary of State under the seal of his office,

shall also be recorded in the offices of the Recorders of the Counties of this State in which the respective corporations so consolidating or merging shall have their original Certificates of Incorporation recorded, or if any of the corporations shall have been specially created by a public Act of the Legislature, then said agreement shall be recorded in the county where such corporation shall have had its principal place of business, and such record, or a certified copy thereof, shall be evidence of the agreement and act of consolidation or merger of said corporations, and of the observance and performance of all acts and conditions necessary to have been observed and performed precedent to such consolidation or merger.

Any one or more corporations organized under the provisions of this Chapter, or existing under the laws of this State, may consolidate or merge with one or more other corporations organized under the laws of any other State or States of the United States of America, if the laws under which said other corporation or corporations are formed shall permit such consolidation or merger. The constituent corporations may merge into a single corporation, which may be any one of said constituent corporations, or they may consolidate to form a new corporation, which may be a corporation of the State of incorporation of any one of said constituent corporations as shall be specified in the agreement hereinafter required. All the constituent corporations shall enter into an agreement in writing which shall prescribe the terms and conditions of the consolidation or merger, the mode of carrying the same into effect, the manner of converting the shares of each of said constituent corporations into shares or other securities of the corporation resulting from or surviving such consolidation or merger and such other details and provisions as shall be deemed necessary or proper. There shall also be set forth in said agreement such other facts as shall then be required to be set forth in certificates of incorporation by the Laws of the State, which are stated in said agreement to be the laws that shall govern said resulting or surviving corporation and that can be stated in the case of a consolidation or merger. Said agreement shall be authorized, adopted, approved, signed and acknowledged by each of said constituent corporations in accordance with the laws under which it is formed and, in the case of a Delaware corporation, in the manner provided in the two immediately preceding paragraphs. The agreement so authorized, adopted, approved, signed and acknowledged shall be filed in the office of the Secretary of State and said agreement shall thenceforth be taken and deemed to be the agreement and act of consolidation or merger of said constituent corporations for all purposes of the laws of this State. A copy of said agreement, duly certified by the Secretary of State under the seal of his office, shall also be recorded as provided in this Section with respect to the consolidation or merger of corporations of this State.

If the corporation resulting from or surviving such consolidation or merger is to be governed by the Laws of any State other than the laws of this State, it shall agree that it may be served with process in this State in any proceeding for enforcement of any obligation of any constituent corporation of this State, as well as for en-

forcement of any obligation of the resulting or surviving corporation arising from the merger, including any suit or other proceeding to enforce the right of any stockholder as determined in appraisal proceedings pursuant to the provisions of Section 61 of this Chapter, and shall irrevocably appoint the Secretary of State as its agent to accept service of process in any such suit or other proceeding and shall specify the address to which a copy of such process shall be mailed by the Secretary of State. Service of such process shall be made by personally delivering to and leaving with the Secretary of State duplicate copies of such process. The Secretary of State shall forthwith send by registered mail one of such copies to such resulting or surviving corporation at its address so specified, unless such resulting or surviving corporation shall thereafter have designated in writing to the Secretary of State a different address for such purpose, in which case it shall be mailed to the last address so designated.

Sec. 59A. *Merger of Parent Corporation and Wholly Owned Subsidiary; Proceedings for:*—Any corporation now or hereafter organized under the provisions of this Chapter or existing under the laws of this State, for the purpose of carrying on any kind of business, owning all the stock of any other corporation now or hereafter organized under the provisions of this Chapter or existing under the laws of this State, or now or hereafter organized under the laws of any other State of the United States of America, if the laws under which said other corporation is formed shall permit a merger as herein provided, may file in the office of the Secretary of State a certificate of such ownership in its name and under its corporate seal, signed by its president or a vice-president, and its secretary or treasurer or assistant secretary or assistant treasurer, and setting forth a copy of the resolution of its board of directors to merge such other corporation, and to assume all of its obligations and the date of the adoption thereof; and a certified copy of said Certificate shall be recorded in the office of the Recorder of Deeds of the County in which the principal place of business of the parent corporation is located, and if the other corporation is also a Delaware corporation and its principal place of business is located in a different County, another certified copy of said Certificate shall be recorded in the office of the Recorder of Deeds of such other County. Thereupon, all of the estate, property, rights, privileges and franchises of such other corporation shall vest in and be held and enjoyed by such parent corporation as fully and entirely and without change or diminution as the same were before held and enjoyed by such other corporation, and be managed and controlled by such parent corporation, and except as hereinafter in this section provided, in its name, but subject to all liabilities and obligations of such other corporation and the rights of all creditors thereof. The parent corporation shall not thereby acquire power to engage in any business, or to exercise any right, privilege or franchise, of a kind which it could not lawfully engage in or exercise under the provisions of the law by or pursuant to which such parent corporation is organized. The parent corporation shall be deemed to have assumed all the liabilities and obliga-

tions of the merged corporation, and shall be liable in the same manner as if it had itself incurred such liabilities and obligations. The parent corporation may relinquish its corporate name and assume in place thereof the name of the merged corporation, by including it in a provision to that effect in the Resolution of Merger adopted by the directors and set forth in the Certificate of Ownership, and upon the filing of such Certificate the change of name shall be completed, with the same force and effect and subject to the same conditions and consequences as if such change had been accomplished by proceedings under the appropriate section of this chapter. Any plan of consolidation or merger which requires or contemplates any changes other than those herein specifically authorized with respect to the parent corporation, shall be accomplished under the provisions of Section 59 of this Chapter. The provisions of Section 61 of this Chapter shall not apply to any merger effected under this Section.

NOTE

MERGER AND CONSOLIDATION

The process of unifying two or more corporations presents combined problems in law and in economics; and no two merger or consolidation statutes are alike. When tested, cases commonly go on their facts. The following materials, therefore, are merely designed to familiarize students with the kind and range of questions which are presented, rather than to suggest a technique.

The power to merge or consolidate must be granted to a corporation by statute. Technically, "merger" is the process of unifying two corporations so that they become one, but the corporation life of both continues in the new corporation. Thus, a "merger" of two railroads results in a single corporation but, because the life of the two component elements continues, franchises granted to the two merging corporations continue to be enjoyed by the merged corporation.

Technically, "consolidation" is the process by which two or more corporations are unified; the component corporations end their corporate life, and a new corporation is formed.

Except where there is some problem of continuing franchise or the like, the technical difference is not of great practical value. The term "merger" is used indiscriminately.

Business or economic merger without corporate repercussion frequently occurs where one corporation buys all or a controlling block of outstanding securities of some other corporation, permitting it to continue in existence but controlling its destinies. This is not, legally, a "merger", but businessmen frequently use the term. Sometimes a holding company may be formed, taking over the stock of two or more corporations and thus unifying the "control". Sometimes, one corporation issues its stock to stockholders of another corporation in exchange for stock of such other corporation, making the second a subsidiary of the first. Sometimes one corporation issues its stock to another corporation in consideration for the sale to it by the other corporation, of its business and assets. There are many possible variants.

In all of these various methods there are different legal problems. The principal ones to be examined are:

(1) Has the corporation a statutory and charter power to merge—or consolidate—or purchase the stock, etc.

(2) Are the terms proposed "fair and equitable" so that the security holders of the component corporations receive securities in the merged or new corporation which equitably represent the interest they had in the component corporation? Many of the contests over mergers and consolidations arise from the conviction that the stockholders of one or other component are being unfairly treated, and are to

receive securities in the new corporation of less value than the value represented by their securities in the old.

(3) Are there specific legal restrictions (e.g. prohibition under anti-trust acts)?

(4) Are the statutory procedures required for the operation being fulfilled by the component companies?

Usually to these questions are added a range of other problems, notably problems of taxation. The result of merger may be realized profits for certain shareholders—and therefore they find themselves subject to taxes, which naturally disposes them to object to the merger. Certain other methods may result in taxation to the corporations involved. Obviously the attorneys involved will wish to work out a method involving the least likelihood of tax liability.

It is not possible to anticipate the range of questions in any given case; and most lawyers rightly consider that each merger is a new problem to be worked out in the light of all the circumstances. Almost of necessity, courts are constrained to deal with such mergers in a like spirit.

OUTWATER v. PUBLIC SERVICE CORPORATION OF NEW JERSEY.

Court of Chancery of New Jersey, 1928. 103 N.J.Eq. 461, 143 A. 729.

BACKES, VICE CHANCELLOR. This bill is to enjoin a merger of five public utilities companies into the Public Service Electric & Gas Company, viz. Essex & Hudson Gas Company, Hudson County Gas Company, Paterson & Passaic Gas & Electric Company, New Brunswick Light, Heat & Power Company, and Somerset, Union & Middlesex Lighting Company. The Public Service Corporation owns all the capital stock of the Electric & Gas Company. The Electric & Gas Company owns more than two-thirds of the capital stock of the merging companies. Directors of the Public Service Corporation compose the board of directors of the Electric & Gas Company; members of the latter board form the directorate of four of the merging companies. A majority of the board of the fifth company is made up of a director and an officer of the Public Service Corporation and a sympathetic stockholder. The plants of the five merging companies are in the possession of the Electric & Gas Company under 900-year leases at net rentals that insure the stockholders of the two lessor companies first named annual dividends of 8 per cent., the next two 5 per cent., and the fifth 4 per cent.

The avowed object of the Public Service Corporation, in merging its subordinate companies, is to get rid of the leases and to acquire the fee to the plants, and to that end caused its directors, directors in control of the subordinate companies, to resolve upon a merger agreement, and upon submission of the agreement to the stockholders caused it to be approved by the votes it controlled. Under the terms of the agreement the stockholders of the companies to be absorbed are to get, in exchange for their shares, 6 per cent., cumulative, preferred stock (non-voting) of the Electric & Gas Company, redeemable in three years at $110. The basis of exchange is one share of preferred stock, at par, for a share of the stock of the two first named merging companies at a value of $137, the next two at $86, and the fifth at $69. The annual yield on this basis would be slightly in advance of the dividends from the net rentals, viz. on the

8 per cent. stock $8.22, on the 5 per cent. $5.16, and on the 4 per cent. $4.14, and it would appear that the appraisal was influenced by a comparison of annual income, rather than the market value of the stocks, of the merging companies, which were then selling, in a narrow market, at approximately the exchange figures. The complainants, stockholders of four of the merging companies, object to the merger as unfair and inequitable.

The attack upon them, that they are actuated in their objection by ulterior motives, finds no justification in the record; surely not as to Fidelity-Union Trust Company, which, as trustee of the Shanley estate, represents more than 10,000 shares of the merging companies. This trustee, an appointee, of this court, was ordered to intervene to protect the interest of the estate. And the subtle insinuation that the Public Service Corporation, in a measure, was moved to the merger pro bono publico, is equally gratuitous. The merger has not the merit of joining two or more utilities for greater public service. It is solely for greater financial convenience of the corporation, albeit economy in financing a public concern of this magnitude, like savings in purchasing any other commodity, is reflected in the rate making by the state.

The Public Service Corporation originally acquired local producing units upon long-term leases, and, as integral parts, fashioned them into its present unified system of statewide service of light, heat, and power. In recent years this leasehold structure proved undesirable in modern financing. Fee ownership was less complicated and more inviting to investors, and conducive to more conveniently financing this vast organization, involving hundreds of millions of dollars borrowed from or invested by the public. Pursuing a policy which was later employed in the instant case, many leaseholds were vacated and estates in fee acquired by merger, until nine companies were left, the five here involved and four others, referred to as "group B." In 1927 the Public Service Corporation offered to the stockholders of the nine companies, for their shares, three alternative bids, cash, exchange for common stock of the Public Service Corporation, or exchange for preferred stock of the Electric & Gas Company; the latter the same as offered by the merger agreement. More than two-thirds of the stockholdings in the five companies here involved was acquired through some one of these offers and the merger followed. Group B was omitted from the merger because the Public Service had not the vote to put it over as to them.

The merger agreement, procedurally, is in legal form, and the right to merge is in entire harmony with the complainants' corporate contract; but, as the merger is, in reality, an appropriation of corporate property by a majority of stockholders, by force of numbers and the grace of the statute, and, while no valid legal objection can be interposed on that score (Colgate v. U. S. Leather Co., 73 N.J.Eq. 72, 67 A. 657), the agreement calls for careful judicial scrutiny, and the burden is on the majority to show that the consideration is fair and equitable, and judgment, as to fairness, is not to be influenced by the heavy note of approval, as it otherwise would be if the vote were independent, as indicated in Berger v. U. S. Steel Corp., 63 N.

J.Eq. 809, 53 A. 68. The decision must rest on the merits, and to that end it has been shown that, when the merger was in contemplation, it was referred by the Public Service officials to responsible bankers to work out a scheme of conversion, and they recommended the alternative offers, and, in respect of the one now the basis of the merger, supported their recommendation at the hearing and stressed the fact that the marketability of the Electric & Gas Company preferred stock gave it a marked advantage. The conversion prices, as already stated, were about the average ruling prices in the market at the time for the stocks of the merging companies. The market, it is true, was "thin." The stocks were closely held as investments, and there was little activity. Sales were few and intermittent, but they were listed, and the stocks dealt in by brokers, and by two of the complainant firms, which specialize in that type of securities, and sufficiently to be acceptable as a guide in determining the "full market value." 2 Comp.St.1910, p. 1661.

The complainants' objection that sales were infrequent and casual, so that no market value can be said to have existed, and that resort should be had to proof or intrinsic value, might have some degree of persuasion, had they come forward with that line of proof; but they contented themselves with supinely resisting the offer, simply claiming that the shares were worth more. How much more they would not say. They refused to fix a price, demurring that they did not care to part with their holdings. That unreasonable attitude was not helpful to the court in determining the fairness of the exchange, and in that respect that issue is held against them.

Now, in addition to fair exchange values, exchange for relative equality of securities in the merged company is implied in all mergers, and relative permanency is a vital element of the securities. The five companies were originally leased to the Public Service Corporation and it assigned the leases to the Electric & Gas Company, which in turn assumed the rental obligation. With this double undertaking, the payment of dividends on the lessor companies' stock is assured beyond peradventure. This security excels in priority all the outstanding obligations of either company. The preferred stock of the Electric & Gas Company, on the other hand, is the next lowest—common stock being lower—security issued by that company, and of this there is now outstanding more than $71,000,000. It is subordinate to outstanding bonds and certificates of indebtedness of more than $82,000,000 and also to debts and liabilities incurred and to be incurred. As against these liabilities the corporation has abundant assets, far in excess in value. There can be little question of the soundness of the preferred stock at this time. The company has made large annual profits, and the future holds promise of continued prosperity. Though the possibility of adversity is decidedly remote, such things have come to pass, as, for instance, the New York & New Haven Railroad Company and the Georgia Central Railroad & Banking Company. Then the dividends on the preferred stock are payable only if earned, whereas the dividends on the stocks of the complainants' companies are insured in practical perpetuity, underwritten, as they are, by the entire Public Service system.

The complainants' resistance and their contention that they ought not to be compelled to exchange their first lien securities for gilt-edged second lien security is not without appeal, and were the decision to rest here there would be some embarrassment in squaring the merger with fairness. But there is a more serious inequity; the preferred stock lacks permanency. It is redeemable within three years at the option of the Electric & Gas Company. Thus the merger, in effect, is nothing less than a forced sale by the majority stockholders to itself at a price fixed by it and payable at its pleasure. The preferred stock is but the equivalent of a 6 per cent promissory note payable in three years at the option of the buyer. The merger legislation countenances no such perversion of the contractual obligations of stockholders inter sese. Continued membership until dissolution, is an inherent property right in corporate existence. A merger is but a fusion of corporate assets and franchises, and an allocation of stock in the merged company, and works a conversion not a destruction of that right. In the ordinary case of merging going concerns and the conversion of share for share upon parity of value, all rights, including voting rights, are reserved to stockholders.

The right to vote is a property right. Lord v. Equitable Life Assurance Society, 194 N.Y. 212, 87 N.E. 443, 22 L.R.A.,N.S., 420. This is adverted to because the loss of it is complained of. That right, however, has lost importance, for the complainants' companies are not going concerns, and never will be, in that respect having been absorbed, and the exchange for non-voting preferred stock is harmless. That may be dismissed, but not the complainants' right of permanent participation in the merged company relatively as they enjoyed that right in the merging companies. The contingency of elimination after three years is unfair, and the right to exercise the option at that time, given by the merger agreement, is oppressive and inequitable. The unlikelihood of the option being exercised, as suggested by the company, is purely speculative, and the burden of anxiety is not to be put upon the complainants. If money should become cheap, and the Public Service could float a new issue at an appreciably profitable lower percentage of interest, redemption would undoubtedly follow, consistently with its past policy of good business.

The redemption feature at $110 offers no adequate compensation, for the complainants would be obliged to reinvest their capital at a correspondingly low rate of return, and besides suffer loss of interest pending reinvestment. It is true the complainants would encounter the same disadvantages if their stocks were appraised under the compensation provision of the statute; but that is presently subordinate, for before the Electric & Gas Company may resort, or the complainants be driven, to that extreme measure, the fairness of the merger must be vindicated (Colgate v. U. S. Leather Co. supra), and it would then be available to the Electric & Gas Company only if non-voting stockholders dissented therefrom, or refused or neglected to convert their stocks. The purpose of the statutory grant of eminent domain in this limited form is to perfect, not accomplish,

a merger. It is not overlooked that under the merger act the merger agreement may provide for "converting the capital stock of each of said merging or consolidating corporations into the stock or obligations of such new or consolidated corporation," thus implying that obligations may be given in exchange. Here obligations are not offered, and the question does not directly arise. On the contrary, the exchange for preferred stock may later become an obligation of the complainants to take. The offer amounts to that. However, fairness in mergers dictates that, when obligations are given in exchange for stocks of the character here involved, they at least should bear a corresponding permanent investment value, such, for instance, as the perpetual interest-bearing certificates of the Electric & Gas Company, or like obligations; otherwise, a merger would be a simple medium for a compulsory sale, and that is not permissible.

The public service corporations contest the right of a court of equity to interfere in the internal affairs of the merging companies, in the absence of fraud, actual or constructive. There is, of course, no suggestion that the majority stockholders entered into the merger agreement with actual intent to defraud the minority. Neither have they earned a decoration for unselfishness. The objection of the defendant corporations is, as an abstract proposition, accepted doctrine, and the principle was recognized in Bingham v. Savings Investment & Trust Co. (N.J.Ch.) 138 A. 659, where dissatisfied stockholders sought to prevent their company from absorbing two others. That case involved purely internal management of a going concern, honestly pursued. Here the situation is different. The complainants' companies are about to be absorbed, and the minority stockholders face the possibility, if not the probability, of being cast into the discard. This by right of might and by means unwarranted and oppressive, and their only appeal for relief is to this court. The merger will be enjoined. * * * [1]

COLE et al. v. NATIONAL CASH CREDIT ASS'N.

JOURNAL SQUARE BANK BUILDING CO. v. NATIONAL CASH CREDIT ASS'N et al.

Court of Chancery of Delaware, 1931. 18 Del.Ch. 47, 156 A. 183.

Two bills, one by Frank H. Cole and others against the National Cash Credit Association, and the other by the Journal Square Bank Building Company against the National Cash Credit Association and another. Rules for preliminary injunction were issued in both causes and were heard together.

Rules discharged.

Bills to enjoin the defendant from proceeding with a merger agreement, by which it, cotemporaneously with Franklin Plan Company, Franklin Thrift and Loan Association and American Cash Credit Corporation, all Delaware corporations, will merge with another existing Delaware corporation called Franklin Plan Corporation.

1 Aff'd. 104 N.J.Eq. 490, 146 A. 916, 1929. For the later history of this case, see, Public Service Electric & Gas Co. v. Federal Power Comm., 1 Fed. Power Comm. 546 (1938).

The Cole bill was filed by a holder of preferred stock of the National Cash Credit Association in behalf of himself and other preferred stockholders. * * * The complainants in the Cole bill object to the merger of their corporation with the Franklin Plan Corporation on the ground that if all the mergers, which are mutually dependent for completion on the carrying through of each, are effected, the asset security underlying the preferred stock of the absorbing company which is to be given in exchange for their present preferred stock will be less in value than that which underlies their present National Cash Credit Association stock; and that this reduction in value is due to the fact that in estimating the asset contribution which each of the merging companies makes to the common pool, the National Cash Credit Association assets are underappraised in comparison with the assets of the other merging companies, whereby the stockholders of the latter are given an advantage over them and other stockholders of the National Cash Credit Association similarly situated. The result, say the complainants, will be that their present stock will, if converted into the proposed new stock, suffer not only in security value but also in market value. * * *

The bill of the Journal Square Bank Building Company assails the proposed merger on the additional ground that if it is consummated as planned, the liabilities of the absorbing company will be greatly increased without any commensurate increase in the quick assets available for debts, that the financial condition of the defendant is more sound than will be that of the corporation into which it is proposed to be merged, and that as a consequence the security which the complainant now has in the assets of its debtor will be greatly impaired.

Rules for preliminary injunction were issued in both causes. They now come on to be heard together upon bills and affidavits.

THE CHANCELLOR. The rules for preliminary injunction in these two cases were heard together. In disposing of the rules, I shall first take notice of the suit filed by the Journal Square Bank Building Company.

Bill of Journal Square Bank Building Company.

The complainant in this suit is a creditor of the defendant. As a general proposition, it is not permitted to a creditor of a corporation to prevent its merger or consolidation with another if the statutory law of its creation authorizes it. 7 Fletcher, Cyc. of Corp. p. 8329; Id. 8411; 8 Thompson on Corporations (3d Ed.) § 6037. * * *

If creditors are in no position to object to a proposed consolidation of their debtor with another corporation because resort to equity against the debtor's assets affords them protection, then a fortiori the express conference upon them by statute of a right of action generally by which not only the assets of their debtor but as well the entire assets of the consolidated company, whether derived from the debtor constituent or not, may be seized in satisfaction, would render less defensible the right of creditors to prevent a consolidation.

The statute of Delaware, under which the corporations here involved were created, expressly provides that in case of merger or consolidation the rights of creditors of the constituent corporations shall be preserved unimpaired, and all debts, etc., of the constituent companies shall thenceforth, after the merger or consolidation, attach to

the consolidated corporation and be enforceable against it to the same extent as if said debts, etc., had been incurred or contracted by it. Section 60, General Corporation Law (35 Del. Laws, c. 85, § 19). * * *

The complainant as creditor, as now appears, will have all the security it now has and considerably more besides. It is difficult then to see how the consolidation can possibly injure it.

But the Journal Square Bank Building Company objects further that it now has the right and so long as its claim lives will continue to have the right, by reason of its debtor's having qualified by license to do business in New Jersey, to sue it in that State, a condition on which its license to do business in that State was granted being that, even though it should withdraw from the State, process might still be served upon it through the Secretary of State of New Jersey; and that this remedy of suit in New Jersey will be lost to the complainant if the merger goes through, because in that event the life of the defendant will be terminated (section 60, Delaware General Corporation Law), and hence the complainant could no longer sue it in New Jersey. Thus, argues the complainant, a "remedy" belonging to it as a creditor will be taken from it, in violation of section 63 of the Delaware act (Rev. Code 1915, § 1977) which provides that the "rights or remedies" of creditors of a Delaware corporation "shall not in any way be lessened or impaired * * * by the consolidation of two or more corporations. * * *"

In the first place I very much doubt that the act of merging would deprive the complainant of its right to a remedy in New Jersey. * * *

But, if the consolidated company could not be sued in New Jersey as an alter ego of the defendant, I still think the complainant has no ground of complaint. The "remedy" of suit somewhere will not be taken from it by the merger. It is expressly reserved to it by statute. I conceive that the word "remedies" as used in the statute refers to those recognized forms of redress which law and equity afford for the securing of rights, without regard to the situs of the jurisdictions, in which they may be asserted. The statute makes lawful and authorizes the merger here under contemplation. If as a result of the statute's operation, a preserved remedy could no longer be asserted in a particular foreign jurisdiction, it would be a strange result if by reason of that fact the stautory authority would be nullified. The right to sue the defendant in New Jersey after it has withdrawn therefrom is a right which the New Jersey law attaches to the granting of a license to do business in that State. If that New Jersey right is in a substantial sense lost by reason of Delaware legislation, a question which as before indicated is doubtful, I think nevertheless that so far as the and merger cases, it does not undertake to guarantee to them juris-Delaware law is concerned the remedy in New Jersey is gone. When our statute preserves remedies generally to creditors in consolidation dictions in which to assert the remedies.

Bill of Cole, et al.

I now take up the case of the preferred stockholders who seek to enjoin the merger. The crucial point on which their complaint turns

is one of value—whether or not they as stockholders in one of the constituents are to receive in exchange for their present holdings, stock which has a value commensurate with the asset contribution which their company is making to the common pool.

This is a question in the last analysis of what are the fair values to be ascribed to the assets of the defendant company in the merger plan.

The statute under which the contemplated merger is proposed to be put through does not compel an objecting minority of stockholders to submit to the compulsion of the majority to the extent of being forced into the status of stockholders in the consolidated enterprise. The option is given to each dissenting stockholder to elect whether he will take his allotment of stock in the consolidated company. If he prefers to dissociate himself from the consolidation, he may, by following the procedure laid down in section 61 of the General Corporation Law (35 Del. Laws, c. 85, § 20), secure a valuation of his stock in money and collect the same as a debt due.

As a general proposition dissenting stockholders are thus put to an election by the statute. There may be circumstances, however, under which a court of equity will say that the duty to make the election does not arise. For instance where the merger is not authorized by law, a dissenting stockholder is under no duty to make his election. He may enjoin its consummation. Jones v. Rhea, 130 Va. 345, 107 S.E. 814; General Investment Co. v. Lake Shore, etc. R. Co. (C.C.A.) 250 F. 160. Furthermore, if consent to the merger be induced by fraud practiced upon a consenting company, a stockholder is under no duty to elect whether he will abide by a merger so induced or take his money. In such a case equity holds that no just alternatives are presented to him for a choice. See Bailey v. Citizens' Gas Light Co., 27 N.J.Eq. 196; Wilson v. Trenton Pass. Ry. Co., 56 N.J.Eq. 783, 40 A. 597. Where also the merger proposes illegally to wipe out a right to accumulated dividends on preferred stock, a court of equity will enjoin it on the application of a preferred stockholder. In such a case the stockholder's election is invited between two alternatives one of which is highly unfair. See Colgate v. U. S. Leather Co., 73 N.J.Eq. 72, 67 A. 657, reversed on other grounds, 75 N.J.Eq. 229, 72 A. 126, 19 Ann.Cas. 1262. From these and other cases which may be cited it thus appears that the election which is given to the stockholder is one that he is not, under any and all circumstances, required to exercise. The exercise of the statutory right of merger is always subject to nullification for fraud. The cases so hold.

In the instant case fraud on the complainants is the ground on which their claimed right to an injunction is based. The fraud charged however is not actual fraud on the part of the directors and majority stockholders. It is constructive fraud based on an alleged discriminatory undervaluation of assets of the National Cash Credit Association on the one hand and an overvaluation of the assets of Franklin Plan Corporation, the consolidated company, on the other. When the fraud charged is of this nature, it must be so plainly made out as to disclose a breach of trust or such maladministration as works a manifest wrong to the dissentients. Raff v. Darrow, 184 Ind. 353, 111 N.E. 189.

The overvaluation or undervaluation as the case may be must be such as to show a conscious abuse of discretion before fraud in law can be made out. Such is the tenor of the opinion of the Vice-Chancellor in Donald v. American Smelting & Refining Co., 61 N.J.Eq. 458, 48 A. 786, 788, reversed on other grounds, 62 N.J.Eq. 729, 48 A. 771, 1116. In Jones v. Missouri-Edison Electric Co. (C.C.A.) 199 F. 64, relief was granted because it was shown that the distribution of the stock of the merged company among the stockholders of the merging companies was "grossly unjust." This circumstance, combined with the fact that the dominating interests in the merger were the beneficiaries of the inequality, moved the court to grant the relief prayed for by the protesting minority.

In the case sub judice, if there is an inequality as between the merging companies, it is not coupled with any showing, or even intimation, that those who have engineered the merger or whose voting influence is great enough to accomplish it, are themselves beneficiaries of the alleged inequality. The case therefore is one that rests on the sole fact of alleged undervaluation and overvaluation of the assets of two of the merging companies.

Where that is the case the rule adopted by this court as applicable to the sale of corporate assets would seem by analogy to supply a sound basis for guidance. While a consolidation is quite distinct from a sale, yet, from the viewpoint of the constituent companies, a sale of assets is in substance involved. Here it is the sale feature of the merger and that alone with which we are concerned. Looking then at the transaction as one where the stockholders of the defendant are in substance selling its assets to another in exchange for securities issued by the latter, what is the rule by which the value derived in exchange for the assets is to be tested for the purpose of discovering whether or not fraud can be said to have been shown? This question is answered by the case of Allied Chemical & Dye Corp. v. Steel & Tube Co., 14 Del.Ch. 1, 120 A. 486. The rule there laid down was that mere inadequacy of price will not reveal fraud. The inadequacy must be so gross as to lead the court to conclude that it was due not to an honest error of judgment but rather to bad faith, or to a reckless indifference to the rights of others interested. There is a presumption that the judgment of the governing body of a corporation, whether at the time it consists of directors or majority stockholders, is formed in good faith and inspired by a bona fides of purpose. Robinson v. Pittsburgh Oil Refining Corp., 14 Del.Ch. 193, 126 A. 46; Davis v. Louisville Gas & Electric Co., 16 Del.Ch. 157, 142 A. 654. * * *

I come now to the question of fact—viz: was there an undervaluation of the defendant's assets, and if so, was it so gross as to indicate bad faith towards the opposing minority? It is significant, that if there was such a grossly unfair discrimination against the class of stockholders among whom the complainants are numbered, only 40,000 shares out of the total of 327,324 are protesting. Apparently about eighty-eight per cent. of the preferred stock outstanding is satisfied with the terms proposed. I do not mean to speak slightingly of forty thousand shares as a negligible number. The figures are given merely to point out that in the judgment of an overwhelmingly ma-

jority of the stock in the interest of which this suit was filed, there is nothing in the situation which warrants a protest. * * *

The complainants speaking for themselves and others, vigorously complain because the stock which they bought has suffered a great market loss. That is unfortunate. It has however nothing to do with the merits or demerits of the proposed merger, which is to be judged in the light of values without reference to prices paid by investors.

After a rather painstaking study of the evidence before me, I fail to see anything in the proposed plan of merger which reveals any fraud, actual or constructive. The complainants therefore are not entitled to be relieved of exercising the election given to them by the statute of choosing whether they will accept stock under the merger or take the necessary steps to secure a valuation and payment in money.

The rules in both cases will be discharged.

BASIS OF MARKET VALUATION—YOUNGSTOWN SHEET & TUBE CO. AND BETHLEHEM STEEL CO. MERGER.

A business precedent (though not a legal precedent) was the case of the merger of Bethlehem Steel Co. and Youngstown Sheet & Tube Co. in the spring of 1930. There the book value of Bethlehem Steel was considerably greater than that of Youngstown Sheet & Tube; on the other hand the earning power of the Youngstown stock was considerably greater than that of Bethlehem Steel. Merger terms were arranged by which Bethlehem Steel agreed to issue one and one-third shares of stock for every share of stock of the Youngstown Sheet & Tube. Although hotly contested on many other grounds, the difference in book value was not adduced as a ground for complaint, and the argument as to the fairness of the merger turned principally on parity of earning power.

Merger Terms

To the Shareholders of
The Youngstown Sheet and Tube Company:

The report of Messrs. Price, Waterhouse & Company as to a fair basis of exchange of the stock of Bethlehem for shares of Sheet and Tube having been challenged, we asked three other leading firms of accountants to examine into the facts and report whether in their opinion the terms of the merger were fair to Sheet and Tube. Their report, which speaks for itself, is published herewith.

Bethlehem Steel Corporation
The Youngstown Sheet and Tube Company

April 2, 1930

Report of Accountants:

New York, N. Y.,
March 31, 1930

Bethlehem Steel Corporation,
The Youngstown Sheet and Tube Company.
Dear Sirs:

At your request we have considered the terms of the proposed merger between Bethlehem Steel Corporation and The Youngstown Sheet

and Tube Company for the purpose of forming an opinion on the question whether the terms of 1⅓ shares of Bethlehem common stock for each share of Sheet and Tube are fair to the shareholders of The Youngstown Sheet and Tube Company.

In considering the questions presented, we have referred to the published annual reports of the two companies for the last five years, and Messrs. Price, Waterhouse & Co. have put at our disposal various tabulations and computations made by them. The accounting officers of Bethlehem have furnished such additional information as seemed to us requisite and have answered all the questions which we have asked. We have also examined the report addressed by Messrs. Ernst & Ernst to Mr. J. A. Campbell under date of March 24, and various reports which have been issued to the shareholders of Sheet and Tube by a committee opposing the merger.

Our conclusion is that on the basis of relative earnings the proposed terms are fair and favorable to the Sheet and Tube Company.

On the basis of net asset values and on the basis of relative working capital they are even more favorable to the Sheet and Tube shareholders.

We shall state briefly some of the principal grounds for our conclusions.

The relative value of the stocks of the companies concerned, in such cases, is determined, so far as it can be determined by an accounting or statistical approach to the question, by four principal factors, viz.:

1. Relative Fixed Charges
2. Relative Working Capital
3. Relative Book Values
4. Relative Earning Capacity.

Relative earnings are most important, but as the others can be dealt with more briefly we propose to discuss them first, especially as they have a bearing on the method of determining relative earning capacity.

1. *Relative Fixed Charges:*

The relative fixed charges of the two companies after the retirement of debt recently effected are as follows:

	Bethlehem	Sheet and Tube
Interest on bonds	$ 5,900,000	$3,600,000
Dividends on preferred stock	7,000,000	825,000
Together	$12,900,000	$4,425,000

The fixed charges in the case of Sheet and Tube are relatively more favorable than in the case of Bethlehem, but, on the other hand, Bethlehem's fixed charges are mainly in the form of dividends on stock, while Sheet and Tube's are mainly in the form of interest, and, in our judgment, therefore, no adjustment is required in respect of this situation.

2. *Relative Working Capital:*

Bethlehem's net working capital as shown by its balance sheet is $179,245,656; that of The Youngstown Sheet and Tube Company is

$74,898,139. On the basis of the relative shareholdings in the consolidated company, Bethlehem's net working capital is thus in excess of the relative contribution on a share basis by Sheet and Tube to the extent of $29,449,378. This figure should be adjusted for dividends declared in 1930, shown by Bethlehem as a liability at December 31, 1929, of $6,550,000 and for marketable securities held as reserve fund assets in excess of the relative figure for Youngstown of $5,170,625, making the excess $41,170,003, or $12.87 per share.

In our opinion, even if the merger is to be considered as based primarily on relative earning capacity, Bethlehem is fairly entitled to an allowance over and above the ratio fixed on the earning capacity basis of at least $12.50 per share for excess working capital.

3. *Relative Book Values:*

The net book value of Bethlehem's common stock, as shown by the common capital stock and surplus (including as surplus its insurance reserve) appearing in its balance sheet at December 31, 1929, is $456,606,409, equivalent on 3,200,000 shares to $142.69 per share. The corresponding net book value of Sheet and Tube is $128,064,081, equivalent on 1,600,000 shares to $80.04 per share.

This comparison is not entirely fair to Bethlehem, inasmuch as Bethlehem has taken up as a liability in its balance sheet of December 31, 1929 dividends not declared until 1930 and not payable until April or May, 1930, amounting altogether to $6,550,000. If adjustment were made for this item, the book value of Bethlehem would be increased to $144.74 per share.

No valuations of the physical assets have been made and it has been suggested that Bethlehem's values are on a relatively higher level than those of Sheet and Tube. Bethlehem's assets could be reduced by $171,000,000 and still leave a book value per share exceeding that contributed per share by Youngstown by the amount already dealt with as excess working capital. As this reduction would be 37% of the total fixed assets, it is abundantly clear that making any reasonable allowance for any differences in methods of figuring book value, Bethlehem's is very much higher than that of Sheet and Tube.

4. *Relative Earning Capacity:*

It is understood that in 1922 and 1923 both Bethlehem and Youngstown acquired several other properties, the Bethlehem Steel Corporation taking in Midvale and Lackawanna, and The Youngstown Sheet and Tube Company taking in Brier Hill and The Steel & Tube Company of America. On this account the only earnings figures which have any significance are those for the six years period from 1924 to 1929 inclusive.

The first question for consideration is the relative weight to be assigned to the earnings of the several years included within the period under review.

This is a matter of the first importance for the reason that the earnings of Sheet and Tube were relatively better than those of Bethlehem in the first three years of the six-year period, whereas the situation is reversed in the second half of the period. Various methods of

weighting are employed. A method employed by the Commonwealth of Massachusetts in determining capital stock values is to take a five-year period and to assign five times the weight to the last year that is assigned to the first, the last but one being assigned four times the weight given to the first year, and so on. A somewhat similar method, was we understand, employed in a recent steel merger. The more heavily the later years are weighted the less favorable is the result to Sheet and Tube. We think that a method which assigned to the average of the years 1927 and 1928 double the weight assigned to the average of the two earlier years would be more than generous to Sheet and Tube. The year 1929 we propose to deal with separately because of the large new stock issues in that year.

The Comparability of Figures:

It is essential to a proper conclusion that the earnings of the two companies should be stated on a fairly camparable basis. From the information given to us, it appears that the operating profits after deducting depreciation are fairly comparable. Two adjustments of the financial figures appear to be called for:

In the first place, Bethlehem has carried direct to reserve the profits of its insurance department including the income from the investments held in connection therewith. Secondly, as pointed out by Messrs. Ernst & Ernst in their report to Mr. Campbell, Sheet and Tube was relieved in 1927 of any Federal income tax on its earnings by reason of certain charges properly made by it to surplus account but properly deductible for income tax purposes. We agree with Messrs. Enrst & Ernst that for present purposes the income tax which Sheet and Tube would normally pay on its earnings should be deducted and Sheet and Tube's earnings reduced. Adjustments of Sheet and Tube's profits in 1928 and 1929 are also required. On the other hand, Bethlehem has considerably over-provided for Federal taxes to an aggregate amount in the five years of $2,408,820.

We have given very careful consideration to the question of the relative provisions for maintenance and depreciation and have carefully noted the points raised by Messrs. Ernst & Ernst in this respect. The provisions made by Sheet and Tube for depreciation are relatively higher than those of Bethlehem, whether computed on the basis of property values or tonnage. The comparison on book value is not, in our judgment, relative, so long as Bethlehem is not receiving any credit for excess book value which it is contributing in the amount, as stated above, of $171,000,000. On the tonnage basis, we think the fact that Sheet and Tube has a larger percentage of lighter products calls for a higher tonnage rate. On the other hand, Bethlehem has more property subject to depreciation which is not reflected in the rated ingot capacity, and to this extent its tonnage rate ought, comparably, to exceed Sheet and Tube's. On the whole, we conclude that Sheet and Tube's provisions for depreciation and depletion, considered separately, are relatively higher than those of Bethlehem.

On the other hand, no fair comparison can be properly made, as recognized by Messrs. Ernst & Ernst in their report, without taking into consideration both depreciation and maintenance. This is par-

ticularly necessary inasmuch as Bethlehem, as shown by its annual reports, accumulates, through its maintenance accounts, substantial reserves which are in effect depreciation provision. Considering depreciation and maintenance together, Bethlehem's charges are in our judgment as high as, and probably somewhat higher relatively than, those of Youngstown. On the whole, it seems to us equitable to accept the accounts as they stand without adjustment in this respect.

Comparative earnings 1925–1928:

Making the adjustments we have noted, the earnings of the two companies available for the common stock are as follows:

	Bethlehem		Sheet and Tube	
	Earnings available for common stock	Per share on 1,800,000 shares	Earnings available for common stock	Per share on 1,200,000 shares
1925	$10,172,541	$5.65	$12,331,180	$10.28
1926	14,069,892	7.82	14,349,762	11.96
1927	9,759,841	5.42	5,358,589	4.47
1928	13,378,664	7.43	9,768,100	8.14
Average:				
1925–1926	12,121,216	6.73	13,340,471	11.12
1927–1928	11,569,252	6.43	7,563,344	6.30
Ratio giving double weight to average of last two years	11,753,240	6.53	9,489,053	7.91

On this basis Sheet and Tube would be entitled to 1.211 shares of Bethlehem for 1 share of Sheet and Tube. We consider the year 1929 separately.

Comparative earnings 1929:

In 1929 the question is complicated by the issue by Bethlehem of 1,400,000 shares for which approximately $136,000,000 was received. As controversy may arise as to the best method of allowing for this change, we state the essential figures for the year as follows:

	Bethlehem	Sheet and Tube
Earnings for common stock as reported	$35,242,980	$20,739,174
Adjustments for insurance and excess tax provisions	2,283,191	268,596
	$37,526,171	$21,007,770
Net earnings from new money included therein	1,746,533	
Adjusted earnings exclusive of earnings on $136,000,000 new capital in the case of Bethlehem	$35,779,638	$21,007,770
The saving on the application of $86,000,000 to debt reduction is	4,224,320	
Making totals of	$40,003,958	$21,007,770

In addition to the adjustments shown above, due weight must be given to plant expenditures which the Sheet and Tube Company had made at its Indiana Harbor plant for additional finishing capacity and which were completed early in 1930 and were not productive of earnings during 1929. The expenditures in question amounted to approximately $10,000,000 and the earnings therefrom are estimated by the management at approximately $2,200,000 on the basis of 90% operation. This situation is of sufficient importance to warrant some special allowance being made therefor, particularly if the earnings of 1929 are to be given heavy weighting. Any adjustment must, of course, deal with the two companies alike. A precise adjustment would involve many assumptions in calculations. A simple calculation will, however, be sufficient to show that no reasonable allowance made would bring Sheet and Tube's earning capacity to a figure which would entitle it to a more favorable basis of exchange than has been agreed upon.

Adding the above estimated earnings of $2,200,000 to the actual Sheet and Tube earnings of $21,000,000 shown above gives a figure of earnings and earnings capacity for Youngstown of $23,200,000. On the basis of an exchange of 1⅓ shares of Bethlehem stock for 1 share of Youngstown, Bethlehem's earnings for 1929 should be double the earnings for Youngstown, shown above, or $46,400,000, leaving a balance over Bethlehem's 1929 earnings, shown in the above table, of $6,400,000 to be derived from additional capital used in expansion. To provide this $6,400,000 Bethlehem will have available the earnings from, first $50,000,000 of new capital, second, $25,000,000 of surplus earnings for 1929—a total of $75,000,000. To produce $6,400,000 this sum would require to yield only about 8½%, and if the conditions are assumed to be such that Sheet and Tube could earn 22% on its new plant, it is reasonable to suppose that under like conditions Bethlehem's new plant would earn considerably more than 8½%.

Summarizing the foregoing, our conclusions are: first, that on the basis of relative earnings (taking into account the years 1925 to 1929, inclusive, and plant under construction at the end of the year) the basis of exchange is favorable to Sheet and Tube; second, that Bethlehem is contributing working capital to the extent of $40,000,000, or $12.50 per share in excess of its rateable contribution on the agreed basis of merger.

We are convinced, therefore, that the terms of the proposed merger are fair and favorable to Sheet and Tube.

Yours very truly,
Haskins & Sells
Lybrand, Ross Bros. & Montgomery
Arthur Andersen & Co.

INVESTMENT COMPANY ACT OF 1940
Release No. 1059

In the Matter of THE CLIFFS CORPORATION and THE CLEVELAND-CLIFFS IRON COMPANY (Investment Company Act of 1940— Section 25 (b))	Advisory Report of the Securities and Exchange Commission in Respect of a Proposed Plan of Consolidation.

TO THE SHAREHOLDERS OF THE CLIFFS CORPORATION:

The Securities and Exchange Commission herewith submits to the shareholders of The Cliffs Corporation, a management investment company registered with the Commission pursuant to the provisions of the Investment Company Act of 1940, an advisory report in respect of a proposed plan to consolidate The Cliffs Corporation (which we shall refer to hereafter as "Cliffs") and The Cleveland-Cliffs Iron Company (which we shall refer to as the "Iron Company") to form a new company to be called The Cleveland-Cliffs Iron Company (which we shall refer to as the "New Company"). This report is submitted pursuant to the request of approximately 2400 shareholders of Cliffs who own in the aggregate approximately 26 percent of the capital stock of The Cliffs Corporation and is made pursuant to the authority conferred upon us by Section 25 (b) of the Investment Company Act of 1940.[3] Information included in this report has been derived from the proxy statements of The Cliffs Corporation and The Cleveland-Cliffs Iron Company used to solicit proxies from the shareholders of such companies in respect of the proposed plan, and from additional information furnished us by the managements of these companies or derived from public information contained in our files. This report should be read in conjunction with The Cliffs Corporation proxy statement dated April 24, 1947.

The purpose of this report is to assist security holders of Cliffs in determining whether or not to approve the plan. The commission has no statutory power to approve or disapprove the plan. Whether or not to accept the plan is a matter to be determined by the individual business judgment of the security holder.

The discussion in this report is arranged in the following order: The history of the formation of The Cliffs Corporation; the capitalization, business and assets of the present Cleveland-Cliffs Iron Company; the provisions of the proposed plan, the effect of the plan upon the shareholders of The Cliffs Corporation; and our conclusion.

Formation of The Cliffs Corporation

The Cliffs Corporation was incorporated in May 1929 as a device for effectuating a liaison between The Cleveland-Cliffs Iron Company and various investment companies which had been organized and sponsor-

[3] Nothing in this report should be deemed to create any implications as to the effect of the plan upon the preferred stockholders of the Iron Company. We express no opinion on this point.

ed by the former firm of Otis and Company and Cyrus S. Eaton. These investment companies had accumulated substantial blocks of the common stocks of Inland Steel Company, Wheeling Steel Corporation, Youngstown Sheet and Tube Company, and of companies which subsequently were merged to form Republic Steel Corporation, for the purpose of combining such steel companies to form a large midwest steel company which, on the basis of assets and productive capacity, would have been the second largest steel company in the United States. The possibility of the occurrence of such a combination was of some concern to the Iron Company because of the possible adverse effect upon its bargaining position in the sale of iron ore which might occur if the number of its customers were substantially narrowed by the proposed merger.[3] It was the desire of the management of the Iron Company to place the Iron Company in the position of being the ore supplier of the proposed new large steel company.

To accomplish this purpose Cliffs was formed and one-half of its shares were issued to the investment companies sponsored by Otis and Company and Cyrus S. Eaton in return for substantial blocks of the common stocks of the four steel companies named above. The stockholders of the Iron Company transferred all of the common stock of the Iron Company to Cliffs in return for the other one-half of the common stock of Cliffs. However, immediately prior to such exchange of Iron Company common stock for Cliffs common stock, the Iron Company declared a stock dividend in the form of preferred stock to the holders of its common stock. This stock dividend totalled 500,000 shares of 5% Cumulative Preferred stock entitled on liquidation to a preference in assets of approximately $50,000,000 and entitled to a sinking fund in the amount of $500,000 for each of the first two years, $750,000 for the next two years, and thereafter $1,000,000 per annum.[4]

Within a few months after the creation of Cliffs, its essential purpose as a preliminary step in the proposed plan of combination of the Iron Company and the steel companies we have mentioned, for the purpose of creating the second largest steel company in the country, had failed.[5]

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[3] William G. Mather, then a director of the Iron Company, stated in a letter to the stockholders of Cleveland-Cliffs Iron Company in respect of the formation of Cliffs:

"In view of the probability of further mergers among the larger steel companies depending for their ore supplies upon the mines of the Lake Superior Company in which event the market for our products might suffer restriction, it has seemed to your directors desirable that our company place itself in a position to participate in such movements. An alliance has therefore been arranged with a strong finance group headed by Mr. Cyrus S. Eaton of Cleveland which owns large blocks of stock in a number of the stronger companies, which alliance will in case we remain independent help to enlarge our market for iron ore, or place ourselves in a stronger position in connection with the whole industry." Report of the Securities and Exchange Commission on Its Study of Investment Trusts and Investment Companies (1942) Part IV, p. 224.

[4] 487,238 shares of this preferred stock issued by the Iron Company as a stock dividend are presently outstanding.

[5] As Mr. Greene, now president of Cliffs and chairman of the board of directors of the Iron Company, testified in the Hearings before the Temporary National Economic Committee (76th Cong. 2d Sess. (1939) pp. 10248, 10269):

"That steel company never was formed, and the cause, therefore, of the formation

Cliffs presently has outstanding 805,734 shares of capital stock owned by approximately 5400 stockholders. Approximately 35% of the outstanding stock of Cliffs is owned by interests affiliated with the management of both companies.

The portfolio of Cliffs has remained virtually static since the company's inception. The company presently owns all of the outstanding 408,296 shares of common stock of the Iron Company and in addition owns: 160,449 shares of the common stock of Republic Steel; 307,500 shares of the common stock of Inland Steel; 30,000 shares of the common stock of Wheeling Steel; and 100,500 shares of the common stock of Youngstown Sheet and Tube Company.[6] The common shares of the Iron Company owned by Cliffs have been valued for several years at $5 per share by Cliffs' management for the purposes of the Investment Company Act of 1940, which requires the board of directors of an investment company to determine the fair value, for the purpose of that Act, of securities having no quoted market value. Upon the basis of this valuation of the Iron Company common stock held by Cliffs and the market value of its holdings of marketable steel stocks, the asset value as of December 31, 1946 of each share of Cliffs common stock, that is the value of the assets which each Cliffs stockholder would have received if on that date Cliffs had been dissolved and its assets distributed in kind, would have been $34.13. As of May 1, 1947, such value would have been approximately $31 per share. The great proportion of this asset value is represented by the steel stocks which at December 31, 1946 had an aggregate market value of approximately $24,000,000; the Iron Company's stock is valued by the management at approximately $2,000,000.

The Cleveland-Cliffs Iron Company

A. Capitalization

The Iron Company is a successor to various predecessors which have operated iron ore mines in the Lake Superior ore district since

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of Cliffs, I would say, may be one of the, if not the most powerful reasons for this relationship was 'out the window' within a very few months."

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"I would say if the cause of the Cliffs Corporation formation had not existed in 1929 that we would not own those stocks today, or would not purchase them. And I also think that my statement is borne out by this fact, that we have since the formation of the Cliffs Corporation not bought a single share of additional stock in any of these companies, with the exception of a small amount of rights under the market that we were awarded a few years ago. So that we had no intention of carrying on the idea that we bought in '29, or rather—not bought, they were acquired in that merger; and they have continued to be held, even though reason for being so has been done away with."

[6] The percentages of the voting securities of the steel companies represented by the stocks in such companies owned by Cliffs and the Iron Company as at December 31, 1946, are as follows:

Cliffs		% of Voting Securities at 12/31/46
160,449	Republic	2.696
100,500	Youngstown	6.000
307,500	Inland	6.276
30,000	Wheeling	3.22

Iron Company			% of Voting Securities at 12/31/46
272,867	Republic		4.58
6,461	Pref.	J. & L.	3.30
81,747	Com.		
1,839	Pref.	Wheeling	.58
3,540	Com.		

the 1850's. Prior to 1929 it had outstanding only one class of stock. In 1929, as has already been indicated, all the common stock of the Iron Company was conveyed to Cliffs. Immediately prior to this conveyance, a stock dividend was declared in preferred stock to the holders of Cliffs common stock. This is the preferred stock which the Iron Company now has outstanding. The Iron Company presently has outstanding 487,238 shares of 5% cumulative preferred stock entitled on any involuntary liquidation of the company to a preference in assets of $48,723,800, and entitled to a sinking fund presently in the amount of $1,000,000 per annum. The company, because of the depression beginning in 1929, early defaulted in the payment of dividends upon its preferred stock and at December 31, 1946 arrearages on such preferred stock amounted to $12,746,146.08 or $26.16 per share.[7] The accumulated sinking fund deficit on such preferred stock at the same date was $14,500,000. As a result of these defaults, no dividends can be paid on the common stock of the Iron Company, which is owned by Cliffs, and none have been paid since 1931. The preferred stock because of such arrearages is entitled to one vote per share or approximately 55% of the voting power in the Iron Company. In each of the years 1940 to 1946, inclusive, the regular dividend of $5 per share was paid on the preferred stock and in addition an aggregate amount of $3 a share was paid on accrued arrearages.

Interests, associated with the management of Cliffs and the Iron Company, owned as of April 3, 1947, approximately 33.5% of its outstanding preferred stock.

In addition to its outstanding preferred and common stock, the Iron Company and its wholly owned subsidiaries have outstanding notes payable to banks and insurance companies aggregating $7,400,000 of which $750,000 is payable in 1948; $5,000,000 between 1951 and 1955 inclusive; $900,000 between 1949 and 1954 inclusive; and $750,000 between 1955 and 1959 inclusive.

B. *Business and Assets*

The Iron Company owns, leases or has stock interest in iron mines, located both on the Michigan iron ore ranges and the Mesaba range in Minnesota. In addition, it owns all of the stock of the Cleveland-Cliffs Steamship Company which owns 14 ore carrying vessels and also operates 3 vessels under contract and 5 vessels chartered from the United States Government. It also owns 75% of the outstanding stock of the Lake Superior & Ishpeming Railroad Company, which serves principally iron mines on the Marquette Range in Michigan, and all of the stock of the Cliffs Power and Light Company, which owns and operates hydro-electric plants located in the Upper Peninsula of Michigan. The power company sells power to the Iron Company in connection with its operations and also sells power to other mines and industries and certain communities. In addition the company and its subsidiaries own and operate coal docks and the company owns an

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[7] On May 17, 1947 the over-the-counter market price on the preferred stock was: bid 85; asked 89.

undivided one-half interest in the Mather Collieries, a coal mine located in Pennsylvania. The company acts as sales agent for all or part of the production of coal mined by others and makes purchase for resale to others. Also owned by the Iron Company is one of the largest strips of timber in the Great Lakes area. This timber is being sold to wood working plants and to the Cliffs Dow Chemical Company in which the Iron Company owns a substantial stock interest. The timber is also used in connection with the company's mining operations.

All of the vessels of the steamship company are leased to the Iron Company and are used almost exclusively in the transportation of the Iron Company's ore and coal. During the past five years, 50% of the power sold by the Cliffs Power and Light Company has been bought by its parent, the Iron Company. Furthermore, during the past five years 74% of the gross revenues of the Lake Superior & Ishpeming Railroad Company was derived from the transportation of iron ore of which approximately 81% was derived from iron ore carried for the Iron Company itself. It is apparent, therefore, that the steamship company, the railroad company and the power company are, to a substantial extent, merely aspects of the ore business in general and the Iron Company's ore business in particular. The revenues of these subsidiaries will vary directly with the operations of the ore industry in general, and of the Iron Company in particular.

In addition to these assets the Iron Company at December 31, 1946 had net current assets of $18,093,810.38 and owned in its own right 272,867 shares of the common stock of Republic Steel Corporation, 6,461 shares of the preferred and 81,747 shares of the common stock of Jones and Laughlin Steel Corporation and 1,839 shares of the preferred and 3,540 shares of the common stock of Wheeling Steel Corporation. As at December 31, 1946 these shares in the three steel companies had an aggregate market value of $11,404,451.49. Thus, at that date the Iron Company had net current assets and listed marketable securities having an aggregate value of $29,498,261.87.

A breakdown upon a precentage basis for the years 1943 to 1946, inclusive, of the sources of the net earnings of the Iron Company is as follows:

Source of Net Earnings	1946 %	1945 %	1944 %	1943 %
Iron Ore Department	51.6	38.3	35.4	52.1
Transportation				
Railroad (Dividends Received)	4.4	10.2	12.1	10.2
Vessels	2.3	10.4	8.3	5.5
Hydro-Electric Power Plants	8.1	7.9	10.1	8.5
Coal Department	6.2	4.3	9.1	8.4
Land and Lumbering Department (including Wood Products)	15.7	16.0	10.0	1.9
Other Dividends Received	11.1	12.1	13.7	12.1
Miscellaneous	.6	.8	1.3	1.3

From these statistics it is clear that the company's ore operations and operations intimately related to the production and transporta-

tion of ore, such as the operations of the railroad, the steamship company and the Cliffs Power and Light Company, accounted for between 66% and 76% of the earnings of the Iron Company for the years covered by the table. Moreover, the item "Other Dividends Received" which accounted for between 11 and 13.7% of the company's earnings for the period covered represents almost exclusively dividends received on the portfolio steel stocks owned by the Iron Company. As we will indicate more fully hereafter, these steel companies represented in the portfolio of the Iron Company and in the portfolio of Cliffs are the primary customers of the Iron Company.

C. Ore Reserves

The Iron Company and about seven principal merchant ore producers in the Lake Superior area compete in the sale of ore to steel companies, the plants of which are located on or near the lower Great Lakes. In connection with its business the Iron Company presently operates sixteen iron ore mines either as owner, lessee, or as a holder of important stock interests. An additional mine with substantial reserves is now in the development stage. As of March 31, 1947 the company's reserves of "assured" and "prospective" high grade ores (including those of one mine under lease to another operator) aggregated approximately 81,350,000 tons, of which approximately 15,600,000 tons represented ore in open pit mines and the remainder represented ore in underground mines. The company also had reserves of low grade ores of approximately 111,000,000 tons and expects, in addition, to discover substantial tonnages of ore. The company estimates that its present "assured" and "prospective" high grade ore reserves are sufficient to enable it to conduct operations for approximately 24 years, based on production rates over the past 10 years. However, the company also indicates that future ore discoveries will enable it to conduct operations for an undetermined additional period of time. The Company's ore reserves are exceeded only by those of United States Steel Corporation which are substantially in excess of those of the Iron Company. In addition, in contrast to the Iron Company's assured and prospective ore reserves, the bulk of which is underground ore, the reserves of United States Steel are to a substantial extent open pit ores.[8]

The management of the Iron Company believes certain competitive advantages will accrue to the company because of the situation of ore reserves in general in the Lake Superior area. Because of the intensive depletion of high grade open pit ores in the last several years induced by the demands of the war effort, it is asserted that the Iron Company in the future will not be as adversely affected competitively as it has been in the past. The company has predominantly produced and sold underground ores and has been at a competitive disadvantage because of the generally higher cost of production of such ores, a cost of production which tends to increase as operations reach greater depths. As open pit ores become more depleted in the fu-

[8] It is estimated that United States Steel Corporation controls over 70% of the open pit reserves now on the Mesaba Range in Minnesota.

ture, it is the management's belief that there will tend to be available a greater proportion of underground ore.[9] The company has recently acquired two open pit mines which it estimates will increase the ratio of its future shipments of open pit ore vis-a-vis underground ores. Nevertheless, the Iron Company's "assured" and "prospective" ore reserves are predominantly underground ores so that its future shipments will presumably still include a greater proportion of underground ores than open pit ores. Moreover, against this possible future competitive advantage to the Iron Company, the possibility of future competition from foreign high grade ores, including high grade ore from deposits being investigated in Labrador, cannot be ignored.

D. Customers

Although the Iron Company sells ore to most of the leading steel companies in the United States, its predominant sales have been to the five steel companies whose common stocks will be held by the New Company, namely Republic Steel Corporation, Jones & Laughlin Steel Corporation, Inland Steel Corporation, Wheeling Steel, and Youngstown Sheet and Tube Company. Approximately 79% of the total sales made by the Iron Company during the past three years have been made to five companies, including three of these companies, Republic Steel, Jones & Laughlin, and Wheeling Steel.[10] By far the greatest part of these sales was made to Republic Steel[11] and Jones & Laughlin. Insignificant amounts of ore have been sold to United States Steel. That company, as we have indicated, has ore reserves substantially in excess of the Iron Company and therefore will presumably not be a large customer of the Iron Company. Although the Iron Company sells ore to Bethlehem Steel Corporation, the second largest steel company in the United States, the amounts sold to such company are much less than the amounts sold in the aggregate by the Iron Company to the steel companies represented in its portfolio and the portfolio of Cliffs.[12] It would appear, therefore, that both the ore operations and the dividends received upon the portfolio investments

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[9] In common with other companies in the ore industry in the Lake Superior area the Iron Company has interested itself in experimentation to determine the commercial feasibility of converting low grade taconites into a commercial ore product. To date the company, however, has expended only approximately $200,000 on this effort.

[10] For the last several years Wheeling Steel Corporation has purchased between 11% and 18% of its ore requirements from the Iron Company.

[11] The Iron Company sold ore to Republic Steel pursuant to an agreement entered into on April 15, 1936 with Republic Steel which provided that for a period of 10 years ending April 30, 1946, the Iron Company would sell and deliver to lower lake ports and Republic Steel would buy an amount of iron ore not less than a specified percentage (but in no event more than 1,800,000 tons of 2,040 pounds in any one year) of all iron ore obtained by Republic Steel in the United States in such year for blast furnace consumption at all northern plants of Republic and its subsidiaries.

[12] Bethlehem Steel Corporation owns extensive foreign and domestic ore reserves. In a registration statement filed with the Commission pursuant to the Securities Act of 1933 (File No. 2-6819), Bethlehem Steel Corporation stated that as at January 1, 1946 its domestic and foreign iron ore properties, excluding its properties on the North coast of Cuba, were estimated to contain at least 105,900,000 net tons of iron ore (excluding tonnages applicable to interests not owned directly or indirectly by the company). Bethlehem Steel Corporation ships Cuban and South American iron ore to its Sparrows Point, Maryland, steel plants.

of the proposed New Company will be somewhat dependent upon the prosperity of the portfolio steel companies.

The Plan and Its Effects Upon the Cliffs Shareholders

As we have already stated, the original purpose of the creation of Cliffs had failed within a few months after its organization. Thereafter the management from time to time for a period of many years considered various plans for the combination of the two companies but was unable to agree upon a plan. The management of Cliffs from time to time also considered dissolving Cliffs. Nothing was done however prior to 1946. In letters dated December 23 and December 27, 1946, signed by William G. Mather, then chairman of the board, and by Edward B. Greene, president, the management announced a proposed plan to liquidate Cliffs by a pro rata distribution in kind of its assets to Cliffs shareholders.[13] It further stated that a proxy statement shortly would be sent to shareholders of Cliffs in respect of a meeting of shareholders for the purpose of dissolving the corporation.

However, on February 18, 1847, the board of directors of Cliffs informed its stockholders that they had suspended the consideration of liquidation plans in order to place before the shareholders of both companies the proposed plan of reorganization which is the subject of this report. A meeting of stockholders to vote on acceptance or rejection of the plan called for May 16, 1947, has been recessed to June 9, 1947.

In explanation of this change in position the management has stated in the proxy statement sent to Cliffs stockholders in connection with the proposal made by the Clark Foundation and other stockholders to dissolve Cliffs:[14] "Your directors believe that this plan which provides a permanent investment in a consolidated company is preferable to breaking up the large capital fund now held by Cliffs."

Briefly described, the plan seeks to accomplish two objectives: (1) the combination of the assets of Cliffs and the present Iron Company into a new company to be called The Cleveland-Cliffs Iron Company, and (2) the reduction of the dividend rate, and the elimination of the dividend arrearages and the sinking fund deficits which have accrued in respect of the present preferred stock of the Iron Company thereby releasing earnings for the Common stock. Under the plan, for each share of Cliffs common stock there will be issued 2¼ shares of the New Company common stock. The existing Iron Company common stock held by Cliffs will be eliminated in the consolidation. Each

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13 The letter of December 23, 1946, stated in part:

"Such a program has been discussed and considered from time to time over the past few years.

"While definite action on the matter by the Board of Directors is not to be taken until December 27, 1946, the management will then recommend that, since the purpose of the organization of the Corporation no longer exists and the Corporation's large holdings of steel stocks are not important in the operation of the Cleveland-Cliffs Iron Company, the best interests of the Cliffs shareholders will be served by distributing to them all of the common stock of the Cleveland-Cliffs Iron Company as well as the steel stocks and cash now held by the Corporation."

14 These stockholders are opposed to the consolidation plan.

preferred shareholder of the present Iron Company will receive a new share of 4½% cumulative preferred stock with a par value of $100 per share, an involuntary liquidating preference of $100 per share and entitled to one vote per share, irrespective of defaults. In addition each share of the present preferred stock of the Iron Company will be entitled to receive one share of the common stock of the New Company. Accrued dividend arrears of $12,746,146.08 on the present preferred stock and the accrued sinking fund deficit of $14,500,000 at December 31, 1946 will be eliminated and a new annual sinking fund equivalent to 15% of the net earnings of the New Company after deduction of preferred stock dividends will be created for the benefit of the new preferred stock.[15] If the plan is completely consummated, the New Company will have a capital structure consisting of $7,400,000 of funded debt; 487,238 shares of preferred stock having a par value of $100 per share and a liquidating preference of $48,723,800; and 2,300,140 shares of common stock of which approximately 79% will be issued to the present shareholders of Cliffs and approximately 21% to the preferred stockholders of the present Iron Company.

The proposed management of the New Company has stated that it presently intends to maintain the portfolio of steel stocks to be acquired from Cliffs in the form of stock and not to convert them into cash. It states that it has made no specific allocation of the funds to be acquired from Cliffs but that these funds will provide a source of funds for future corporate needs for the production and development of high and low grade ore reserves,[16] although it does not foreclose the possibility of the use of such funds for other purposes. Moreover this management does point out that the liquid assets possessed by the present Iron Company would be sufficient to provide funds for such purposes for several years.

The earnings of Cliffs have been derived from the dividends it receives from its portfolio of common stock of four different steel companies.[17] The Cliffs management points out, in advocating the plan, that the pro forma earnings on the 2¼ shares of the New Company's common stock which will be issued for each share of Cliffs stock would have, in every year but one between 1937 and 1946 inclusive, exceeded these earnings of Cliffs.[18] In fact, this appears to be the basis for its

[15] The new sinking fund will take effect after 1956, or at the date all of the New Company's funded debt is retired, whichever date occurs first.

[16] In respect of the development of types of low grade ore, not now considered commercial partially because present beneficiation plants are not suited to the treatment of such types of ore, the company has expended only nominal amounts in investigating their commercial possibilities and at present has only a nominal allocation for this purpose. Although it is indicated that the development of such low grade ores will become increasingly important as high grade ores are exhausted by the ore industry in general, the commercal feasibility of processing low grade ores into a marketable grade has not been proven nor has it been determined that such beneficiation of low grade ores, even if technically feasible, can compete with high grade foreign ores which may be imported to this country in the future.

[17] It should be noted that for the last ten years the steel companies, the stocks of which are contained in the portfolio of Cliffs, have paid out only approximately 47% of their earnings as dividends after the preferred dividends requirements of such companies.

[18] By the term "pro forma earnings" we mean the earnings which would have accrued to the common stock of the New Company if the proposed consolidation had

recommendation of the plan to the Cliffs shareholders. However, the management does point out that if the earnings on the present Iron Company common stock now held entirely by Cliffs had been available to Cliffs in such years, the aggregate of such earnings and the dividends received on the steel stocks held in the portfolio of Cliffs per each share of Cliffs would have exceeded in every year except 1938 the pro forma earnings on the 2¼ shares of the common stock of the New Company. These earnings could not have been realized by Cliffs because no dividends can be paid on its common stock of the Iron Company until the dividend arrearages and sinking fund deficits on the outstanding preferred stock are eliminated. However, as we have indicated, the Iron Company presently has net current assets and marketable steel stocks which it owns in its own right having an aggregate value as at December 31, 1946 of approximately $29,500,000. By the terms of the Iron Company's bank loans it must maintain, until such bank loans are paid, a net working capital position of at least $8,500,000. We do not know whether or not the working capital requirements of the company would require the retention of all or part of the remaining $21,000,000 of these assets. However, for the purpose of an analysis and on the assumption that such funds are not required as working capital, they would enable the Iron Company to meet immediately all of its dividend arrearages and to make substantial inroads on its sinking fund deficits. If we further assume, again only for the purpose of analysis, that the earnings for the Iron Company will continue at least at the same rate as for the year 1946 it might be that after several years the company would be able to meet not only its current dividend requirements and current sinking fund requirements, but also be able to eliminate through operations and possible acceleration by additional financing the remaining sinking fund deficit. If the liquid assets of $21,000,000 to which we have referred are needed for investment in

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been consummated on December 31, 1936. The figures used herein and other figures in this report in respect of the plan are predicated upon an assumed 100% acceptance of the plan.

The following table sets forth for each of the years 1937 to 1946, inclusive, the actual earnings for each share of Cliffs common stock, the earnings which would have accrued on the Iron Company common stock on a per share basis for Cliffs stock if such earnings had been legally available, the pro forma earnings per share of new common stock and the pro forma earnings available for the 2¼ shares of the new common stock.

Year Ended Dec. 31	Net Income (Dividends and Interest) per Share of Cliffs Common stock	Net Earnings which would have accrued to each share of Cliffs common if the earnings on the Iron Company stock had been available	Pro Forma Net Earnings Available per New Common Share	Pro Forma Net Earnings Available per 2-1/4 New Common Shares
1946	$1.18	$2.39	$1.36	$3.06
1945	.96	1.58	1.00	2.25
1944	.96	.88	.75	1.69
1943	.95	1.57	.99	2.23
1942	1.07	2.01	1.18	2.65
1941	1.35	2.09	1.31	2.95
1940	.80	2.46	1.25	2.81
1939	.40	1.22	.68	1.53
1938	.26	2.02*	.51*	1.15*
1937	.94	3.29	1.59	3.58

* Denotes loss

the company's business, such investment may increase earnings. Furthermore, as all earnings in the future are directed to retirement of preferred stock and payment of current dividends and dividend arrearages, the value of the Iron Company's common stock owned by Cliffs will tend to increase as dividend arrearages and the sinking fund deficit decline. These matters are worthy of consideration by the Cliffs stockholder since they indicate a possibility that Cliffs may ultimately be enabled to obtain all of the earnings of the Iron Company common stock.

As against this possiblity in the indefinite future the proposed plan, if consummated, will make available to him as dividends, to the extent not needed in the business, 79% of future earnings in excess of $2,192,571, the total annual preferred dividend requirement. But this will cause a substantial change in his position.[19] In place of his position as a shareholder in an investment company having one class of securities representing a first claim on a portfolio of common stocks of four steel companies, and the common stock of the present Iron Company, he will become a common stockholder of a single company engaged primarily in the production and sale of iron ore. The common stock in such company will be subordinate to approximately $56,000,000 of funded debt and preferred stock. The steel stocks upon which he presently has a first claim become subject to the prior claims of the funded debt and preferred stock of the New Company.[20]

The question for the Cliffs shareholder to decide is whether the possibility of receiving larger earnings and dividends on the 2¼ shares of the common stock of the New Company than has been available for each share of Cliffs stock in the past, by reason of the lower dividend rate on the new preferred stock and the removal of the dividend arrears and sinking fund deficit as a block on dividends from the earnings of the Iron Company, is sufficient to outweigh the substantial change which occurs in his position.

We now discuss considerations which are important in formulating a judgment on this question.

First: The pro forma earnings of the New Company for the years 1937 to 1946 are useful merely as a guide to an estimate of the amount, regularity, stability and continuity of future earnings and dividends on the New Company's stocks. They should be considered in the light of the fact that most of the years in question were years of high steel production induced to a substantial degree by World War II. Furthermore, during the years in question, overall costs of operations have increased and profit margins have been reduced. It may be questioned that such increased costs can be lowered as rapidly as declines in sales, if such declines should occur.

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19 We do not wish to imply that the preferred stockholders are not also making substantial concessions under the plan.

20 As at December 31, 1946, the aggregate of the net current assets of the combined company and its combined portfolio of steel stocks would have been slightly less than the aggregate preferential claim on liquidation of the New Company's funded debt and preferred stock. Dividends received on the combined portfolio for the year 1946 were insufficient to cover the preferred stock dividend requirement of the New Company so that part of such dividends would have had to have been met from earnings resulting from the company's ore operations.

Second: The company's operations depend largely upon the operations of the steel industry, an industry the operations of which are extremely cyclical in character. More particularly the New Company's operations will be dependent on the operations of the steel companies which will be included in the portfolio of the New Company and which will be the principal customers of the New Company. Moreover, ore production and sales in the past at least have tended to be somewhat more cyclical than steel production. Ore sales and production have had a tendency to drop at a somewhat greater pace than declines in steel production, although they also tend to rise at a greater pace than steel production.[31]

Third: The common stock of the New Company is what is known as a "leverage" stock because of the presence of substantial quantities of senior securities in its capitalization which have a prior fixed claim on the earnings of the company. The existence of this fixed claim on earnings operates to cause a greater proportion of change in the earnings applicable to common stock than occurs in the aggregate earnings

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[31] Compare the schedule on page 11 of the Cliffs proxy statement indicating tons of ore sold by the Iron Company in typical years with total tons of steel production of ingots and castings in such years. It will be noted that in 1929 the Iron Company sold approximately 4,000,000 tons of ore and that in such year total production of ingots and castings by the steel industry aggregated approximately 63,000,000 tons. By 1932 sales of ore by the Iron Company had declined to 660,000 tons, a decline of approximately 83⅓% as against its sales in 1929 whereas steel production declined from 63,000,000 tons in 1929 to approximately 15,000,000 tons in 1932, a decline of about 76.2%. However, between 1939 and 1942 ore sales by the Iron Company rose much more rapidly than production by the steel industry in the same period and from 1942 to 1946 sales by the Iron Company of iron ore tended to remain around 5,000,000 tons during a period of the highest steel production in history.

The following statistics of ore production as against steel production at various stages in the cycle of such production also illustrate this phenomenon:

	Iron Ore Production (Net Tons)				Steel Production (Net Tons)			
Year		Total		Exclusive of U. S. Steel		Total		Exclusive of U. S. Steel
1929	A	81,791,046*	B	51,250,481	A	63,205,490*	B	38,712,490
1932	C	11,028,546*	B	6,978,269	C	15,322,901*	B	9,802,157
1944	C	124,342,562*	B	74,500,562	C	89,641,600	D	58,826,600
1946	E	79,759,680*	F	41,787,680	B	66,590,000	F	45,290,000

(* — converted from gross tons)

Sources: A — Mineral Resources of the U. S.
B — Standard & Poor's Corp. Records
C — Minerals Yearbook
D — Moody's Industrials
E — Bureau of Mines (Preliminary Figures)
F — Annual Report of United States Steel Corp. to its stockholders

Index-Numbers (1929 equals 100%)

	Iron Ore Production (Net Tons)		Steel Production (Net Tons)	
Year	Total	Exclusive of U. S. Steel	Total	Exclusive of U. S. Steel
1929	13.5%	100 %	100 %	100 %
1932	152.0%	13.6%	24.2%	25.3%
1944	100%	145.4%	141.8%	152.0%
1946	97.5%	81.5%	105.4%	117.0%

available for both preferred and common stock.[22] This leverage factor in the New Company's capital structure is further intensified by the fact that the portfolio of steel stocks to be held by the New Company are also leverage stocks, although not to the same degree as the New Company's common stock, because of the fact that the capitalization of these companies includes a greater proportion of common stock equity. Nevertheless, as we have already indicated, the company's ore operations are at least somewhat related to the operations of the portfolio companies and the leverage of the common stock of the New Company plus the cyclical character of the operations of the company and its customers will intensify the fluctuations in the earnings of the common stock upon increases and decreases in aggregate earnings available for both preferred and common stocks of the New Company.[23] Of course, as preferred stock of the New Company is retired this leverage factor will lessen in its effects.

The stock of Cliffs Corporation is not a "leverage" stock; Cliffs has no senior securities outstanding. Although the portfolio of steel stocks held by Cliffs consists of leverage stocks, such leverage is much less pronounced than that of the New Company's common stock.[24] From

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22 For example, on a pro forma basis the New Company would have earned approximately $5,000,000 for the year 1946. The annual fixed dividend requirement on the preferred stock would have been approximately $2,200,000. Pro forma earnings of approximately $2,800,000 would have been available for the new common stock. If the aggregate earnings of $5,000,000 for both the preferred and common stock were to decline to approximately $3,000,000, a decline of approximately 40%, the preferred stock claim of approximately $2,200,000 would remain unchanged and the earnings on the common stock would be reduced to approximately $800,000, a decline of approximately 70%. If earnings increase, the earnings of the common stock would similarly be accelerated. In this connection the dividend restriction on common stock of the New Company should also be considered. Except to the extent new capital is furnished through issuance of new securities junior to the preferred, no dividends may be paid on common stock if after such payments the aggregate dividends on preferred and common, and purchases of common stock would exceed earnings subsequent to the consolidation plus $4,000,000.

23 The effect of the phenomena we have discussed is illustrated by an examination of the pro forma earnings of the New Company for the years 1937 to 1946 inclusive. It will be noted that such earnings for the period, 1937 to 1940 inclusive, fluctuated from a deficit of 51¢ per share in 1938 and an inability to earn the preferred stock dividend on the New Company stock in that year, to a high of $1.59 a share for the year 1937. Average earnings for the four year period were approximately 75¢ per share of the new common stock. Similarly, during the period 1941 to 1946, inclusive, a period of capacity or near capacity steel production, such earnings fluctuated from a low of 99¢ per share for 1943 to a high of $1.36 per share for 1946. Average pro forma earnings for this period were about $1.10 per share. It is to be noted also that the management's proposal to pay an initial dividend of 25¢ on each share of the New Company's common stock represents on an annual basis a dividend rate which could not have been earned in three of the ten years for which pro forma earnings are presented.

24 The following table is presented to indicate the ratio of senior securities existing at December 31, 1946 to the total capitalization of the four steel companies and the New Company.

	Inland		Republic		Wheeling		Youngstown		New Company	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Funded Debt	$ 57,000,000	30.9	$ 61,440,000	18.1	$ 23,500,000	20.2	$ 30,000,000	15.1	$ 7,400,000	10.3
Preferred Stock	—	—	28,214,300	8.3	36,316,000	31.2	—	—	48,723,800	67.8
Common Stock	62,500,000	33.8	132,520,021	39.1	28,477,950	24.4	105,088,053	52.7	2,300,140	3.2
Surplus*	65,162,473	35.3	116,508,027	34.5	28,142,265	24.2	64,213,101	32.2	13,423,410	18.7
	$184,662,473	100.0	$338,682,348	100.0	$116,436,215	100.0	$199,301,154	100.0	$ 71,847,350	100.0

this point of view, the dividend income of Cliffs will tend to be somewhat more stable and regular than earnings applicable to the New Company's common stock and will also tend to decline less drastically than the earnings applicable to the New Company's common stock.

Finally, an important question which Cliffs shareholders seek to resolve in reaching a judgment on the plan, particularly those who may not want to concentrate their investment in the iron-ore business, is how the immediate market price of the common stock of the New Company will compare with the present asset value of their Cliffs stocks. Obviously no one can forecast with accuracy what the market value of the common stock of the New Company will be. However, the following comments are worthy of consideration on this question. In our opinion, the applicable present value of the Cliffs common stock for the purpose of an analysis of the plan is the asset value of such stock, that is the underlying market value of the steel stocks and the fair value of the Iron Company's common stock (which the management has appraised as of December 31, 1946, for the purposes of compliance with the Investment Company Act of 1940, at $5 per share).[25] This value as at December 31, 1946, was approximately $34 per share and at May 1, 1947, was approximately $31 per share, in each case accepting as the value of the Iron Company common stock the valuation placed upon such stock by the management of Cliffs. This is the value of the assets which will actually be conveyed to the New Company if the requisite vote of the Cliffs stockholders is obtained.[26] Moreover, the management of Cliffs in its proxy statement has not foreclosed the possibility of dissolution if the proposed consolidation fails of consummation.

The average pro forma earnings per share of the New Company's common stock of 96¢ per share for the ten year period, 1937 to 1946 inclusive, would have to be capitalized at a rate of approximately 14 times in order to arrive at a market price for the New Company's 2¼ shares of common stock equal in value to the present asset value of each share of Cliffs stock. The pro forma average earnings of $1.10

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* Excluding surplus reserves, and in the case of the New Company "Surplus arising from adjustment of properties and investments to amounts established for federal income tax purposes" ($12,357,347), since depletion and depreciation provisions arising from such adjustments are not charged against income.

	Inland	Republic	Wheeling	Youngstown
Common Shares owned by Cliffs 12/31/46	307,500	160,449	30,000	100,500
Market value 12/31/46	$12,300,000	$4,472,516	$1,222,500	$6,758,625

25 This does not mean that we believe the management valuation necessarily represents the actual value of such stock. We accept such valuation merely for the purpose of our analysis. The board of directors in its resolution determining such fair value stated that the value of such stock is difficult to determine, being dependent in part on the value of the Iron Company's interest, directly and as a stockholder in other companies, in iron ore deposits of undetermined extent and value, and is subject to substantial differences of opinion.

26 The management of Cliffs has indicated in its proxy statement that the steel stocks owned by Cliffs will be taken on the books of the New Company at their market value at the date the consolidation is declared effective.

per share on the New Company's common stock for the year 1941-1946 inclusive (years of substantial steel production) would have to be capitalized at approximately 13 times such earnings in order to arrive at a market value approximately equivalent to the present asset value of each share of Cliffs stock. Similarly the proforma earnings of the 2¼ shares of the New Company's common stock for the year 1946 ($3.06) would have to be capitalized at a rate of approximately 10 times such earnings in order to arrive at a market price approximately equivalent to the market value of the assets of Cliffs attributable to each share of its stock.

In view of the high leverage and other characteristics of the New Company common stock, it is questionable that the market will at least initially capitalize the New Company's common stock at these rates of capitalization which would be necessary to have the immediate market price of the 2¼ shares of New Company common stock approach in amount the present asset value of each share of Cliffs stock.[27]

However, if the plan is not consummated and Cliffs is not dissolved, the Cliffs shareholder should recognize that the market value of his Cliffs stock has in the past been substantially less than the asset value of such stock.[28]

Conclusion

We have attempted to indicate for the consideration of Cliffs shareholder the more significant factors which he must evaluate in order to form a judgment on whether or not to assent to the plan. His alternatives are—

(1) To vote for the plan, in which case he must make the exchange if the plan is consummated.

(2) To vote against the plan or to refrain from voting, in which case he may make the exchange or exercise his appraisal rights under the Ohio Corporation Law if the plan is consummated.

Whether or not to assent to the plan is a question which the Cliffs stockholder must decide in accordance with his own business judgment. It is to be noted that if the plan does become effective, a non-assenting Cliffs shareholder who does not wish to accept the exchange is not

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[27] The management of Cliffs does not contend that the immediate market value of the 2¼ shares of new common stock which each share of Cliffs stock will receive will be equal to the asset value of such stock. Instead, E. B. Greene, president of Cliffs, in a letter to its stockholders dated May 6, 1947, states:

"The management believes that the earnings and dividend possibilities of the new corporation's common stock outweigh any immediate stock market dollar advantage which might be gained through dissolution."

[28] The following table indicates the asset value and market price per share of Cliffs at each of the year ends 1940 to 1945 inclusive:

Year Ended Dec. 31	Asset Value*	Approximate Market Value
1940	24.75	17-3/8
1941	20.59	11-7/8
1942	18.17	10
1943	20.94	14
1944	23.73	18-1/8
1945	32.53	26-1/2

* Using valuation of 408,296 common shares of The Cleveland-Cliffs Iron Company at $5.00 per share or an aggregate of $2,041,480.

offered, under the terms of the plan, in recognition of his right under the Ohio law to obtain the "fair cash value" of his shares, the alternative of receiving the asset value of his shares based on the market value of the steel stocks and the management's appraisal of the fair value of the Iron Company stock held by Cliffs.[29] Instead the plan, if ratified, would require such shareholder to follow strictly the statutory procedures prescribed by the Ohio law for asserting and enforcing his right to the "fair cash value" of his shares, a method which requires him to adhere to rather rigorous procedures and dead-lines and which may involve legal proceedings in Ohio courts.[30]

By the Commission (Chairman Gaffrey and Commissioners McConnaughey, McEntire, Hanrahan, and McDonald).

Orval L. DuBois,
Secretary.

(Seal)

May 21, 1947.

C. DISSOLUTION

NEW YORK STOCK CORPORATION LAW

§ 105. *Dissolution without judicial proceedings.* Any stock corporation, except a moneyed or railroad corporation (other than a railroad corporation which shall have conveyed all of its property, appurtenances and franchises, pursuant to lawful authority), may be dissolved at any time by the filing in the office of the secretary of state of a certificate which shall be entitled and endorsed "Certificate of

29 See footnote 24, supra.

30 The Ohio appraisal statute gives the Cliffs shareholder who does not vote in favor of the plan the right to the fair cash value of his shares as of the day before the vote on the plan. The procedure is as follows:

(1) Within 20 days after the day of the vote, such shareholder shall object in writing to the action taken and shall demand in writing the payment of the fair cash value of his shares, stating the number and kind of shares held, and the amount he claims is the fair cash value.

(2) Within 10 days after receiving the demand, the corporation shall inform such shareholder in writing whether it will pay the demanded amount, and, if it refuses to pay such amount, it shall offer in writing to pay an amount as and for such fair cash value.

(3) If the corporation shall not agree to pay the amount demanded by the shareholder, or the shareholder shall not agree to accept the amount offered by the corporation, either the corporation or the dissenting shareholder (if he followed the above procedure) may within 6 months from the day of the vote on the plan (and not thereafter) petition the Court of Common Pleas of Cuyahoga County, Ohio, to determine the fair cash value of his shares as of the day before the vote on the plan.

(4) If the petition is not filed within 6 months from the date of the vote, the fair cash value shall conclusively be deemed to be the amount the corporation offered to pay to the shareholder.

(5) If the petition is filed, the statute provides for a procedure involving a hearing on the petition, the appointment of three appraisers, a report by the appraisers, a hearing on the appraisers' report, and the determining of the fair cash value of the shares on the basis of the report.

(6) Payment shall be made within 30 days after the fair cash value is agreed upon or determined.

(7) The costs of the proceeding, including reasonable compensation to the appraisers to be fixed by the court, shall be assessed or apportioned as the court may consider equitable.

In this connection, it should be pointed out that 3,626 shareholders owning approximately 50.8% of the outstanding shares are located in states other than Ohio, the jurisdiction in which appraisal rights must be asserted.

dissolution of ———, pursuant to article ten of the stock corporation law" (the blank space being filled in with the name of the corporation) and shall state:

[As amended by Ch. 136, L. 1943.]

1. The name of the corporation, and, if it has been changed, the name under which it was originally incorporated.

2. The date of filing of the certificate of incorporation in the office of the secretary of state; or, if the corporation is created by a special law and has no certificate of incorporation, the chapter number and year of passage of such law.

3. That the corporation elects to dissolve.

4. The name and post-office address of each of its directors, and the name, title and post-office address of each of its officers. If the post-office address of any such director or officer be in a city, the street and number or other particular description thereof. * * *

7. Upon the filing of such certificate of dissolution, the secretary of state shall make duplicate certificates that such certificate of dissolution has been filed and that it appears therefrom that such corporation has complied with this section, and that it is dissolved. * * *

8. Such corporation shall continue for the purpose of paying, satisfying and discharging any existing liabilities or obligations, collecting and distributing its assets and doing all other acts required to adjust and wind up its business and affairs, and may sue and be sued in its corporate name.

9. After paying or adequately providing for the liabilities and obligations of the corporation the directors, with the written consent of the holders of a majority of the outstanding shares of the corporation entitled to vote thereon, may sell the remaining assets or any part thereof to a corporation organized under the laws of this or any other state, and take in payment therefor the stock or bonds or both of such corporation and distribute them among the stockholders, in proportion to their interest therein, but no such sale shall be valid as against any stockholder who, within sixty days after mailing of notice to him of such sale, shall apply to the supreme court in the manner provided by section twenty-one, for an appraisal of the value of his interest in the assets so sold and unless within thirty days after such appraisal the stockholders consenting to such sale, or some of them, shall pay to such objecting stockholder or deposit for his account, in the manner directed by the court, the amount of such appraisal; upon such payment or deposit the interest of such objecting stockholder shall vest in the person or persons making such payment or deposit.

10. At any time after three years from the filing of the certificate of dissolution of a corporation heretofore or hereafter dissolved pursuant to this section, the surviving directors, or a majority of them, may give notice of the time and place for the presentation of all claims and demands against the corporation, which notice may require all creditors of and claimants against the corporation to present in writing and in detail at the place specified their respective accounts and demands to the directors by a day therein specified, which shall not be less than forty days from the first publication of such notice. Such notice shall be published at least once a week for two successive weeks

in a newspaper published and circulating in the county in which was located the principal offce of the corporation prior to its dissolution. On or before the date of the first publication of such notice a copy thereof shall be mailed, postage prepaid, to each known creditor of and claimant against the corporation at his last known address. A copy of such notice, with proof of the publication and mailing thereof as aforesaid, shall be filed in the office of the county clerk of the said county in which was located the principal office of the corporation prior to its dissolution. The giving of such notice shall not operate to revive any claim or demand against the corporation, its property and assets, directors and stockholders, which theretofore shall have become barred by lapse of time or other cause; and all claims and demands which shall not be filed as provided in said notice and on or before the date therein specified shall be forever barred as against the property and assets of the corporation and its directors and stockholders.

11. At any time after the expiration of the time for filing claims specified in the notice provided for in paragraph ten of this section, the surviving directors of such dissolved corporation, or a majority of them, may provide for the termination of its corporate existence by filing in the office of the county clerk of the county specified in said paragraph ten of this section a certificate which shall be entitled and endorsed: "Certificate of termination of ——— pursuant to article ten of the stock corporation law" (the blank space being filled in with the name of the corporation), and shall state:

a. The name of the corporation, and, if it has been changed, the name under which it was originally incorporated.

b. The date of filing of the certificate of dissolution in the office of the secretary of state.

c. The date of filing of the copy of the notice provided for in paragraph ten of this section in the office of the county clerk.

d. That the corporate existence will expire ninety days after the date of the filing of the certificate of termination.

e. The name and post office address of each of its directors, and the name, title and post office address of each of its officers. If the post office address of any such director or officer be in a city, the street and number or other particular description thereof. * * *

12. Notwithstanding the termination of the corporate existence of the corporation, any valid and subsisting claims and demands which shall have been filed as provided in paragraph ten of this section may be prosecuted, and any suits pending at the date of such termination of existence may proceed, against the surviving directors, as trustees, who may continue to be sued in the corporate name. Judgment when obtained in any such suit shall be binding upon all the property and assets of the dissolved corporation to the same extent as if such corporation had not been dissolved and ceased to exist; and the surviving directors, or a majority of them, and their successors, shall continue to have power to pay, compromise, defend and satisfy such claims, demands, suits and judgments, and to administer, sell and distribute the remaining assets of the corporation for the purpose of finally winding up its affairs.

NEW YORK GENERAL CORPORATION LAW

§ 103. *Petition in case of deadlock.* Unless otherwise provided in the certificate of incorporation, if a corporation has an even number of directors who are equally divided respecting the management of its affairs, or if the votes of its stockholders are so divided that they can not elect a board of directors, the holders of one-half of the stock entitled to vote at an election of directors may present a verified petition for dissolution of the corporation as prescribed in this article.

DELAWARE GENERAL CORPORATION LAW

Sec. 39. *Dissolution; Proceedings for:*—If it should be deemed advisable, in the judgment of the Board of Directors, and most for the benefit of any corporation organized under this Chapter, that it should be dissolved, the said board, within ten days after the adoption of a resolution to that effect by a majority of the whole board at any meeting called for that purpose, of which meeting every director shall have received at least three days' notice, shall cause notice of the adoption of such resolution to be mailed to each stockholder of record having voting power, and also cause a like notice to be inserted in a newspaper published in the county wherein the corporation shall have its principal office in the State of Delaware, at least three weeks successively, once a week, next preceding the time appointed for the same, of a meeting of the stockholders having voting power, to be held at the office of the corporation, to take action upon the resolution so adopted by the Board of Directors, which meeting may, by consent of a majority in interest of the stockholders present in person or by proxy, having voting power, be adjourned or recessed from time to time. At said meeting a vote of the stockholders, having voting power, by ballot in person or by proxy, shall be taken for and against the proposed dissolution, which vote shall be conducted by two Judges appointed for the purpose, either by the directors or by the said meeting. Said judges shall decide upon the qualifications of voters, and accept their votes, and when the voting is completed, count and ascertain the number of shares voted respectively for and against the dissolution, and shall declare whether the persons or bodies corporate holding two-thirds of the voting stock of said corporation have voted for the proposed dissolution; and shall make out a certificate accordingly, stating the number of shares of stock having voting power issued and outstanding and entitled to vote thereon, and the number of shares voted for and the number of shares voted against the dissolution, respectively, and shall subscribe and deliver said certificate to the secretary of the corporation. If it shall appear by said certificate of the judges that the persons or bodies corporate holding two-thirds of the stock of said corporation having voting power have voted in favor of the dissolution, a certificate certifying that such dissolution has been authorized in accordance with the provisions of this section and the names and

residences of the directors and officers shall be made under the seal of the corporation and signed by its President or a Vice-President and its Secretary or an Assistant Secretary, and the President or such Vice-President shall acknowledge the said certificate before an officer authorized by the laws of the State of Delaware to take acknowledgments of deeds; and the said certificate so executed and acknowledged shall be filed in the office of the Secretary of State, who, upon being satisfied by due proof that the requirements aforesaid have been complied with, shall issue his certificate that such certificate has been filed, and the Secretary of State shall cause his certificate to be published in one issue in a newspaper published in the county wherein was situated the principal office in the State of Delaware of the dissolved corporation. The Secretary of State shall ascertain the charge for publishing the certificate of dissolution as aforesaid, and collect the amount from the corporation before the certificate of dissolution is issued, and upon the filing in the office of the Secretary of State of an affidavit of the manager or publisher of the said newspaper that said certificate has been published one time, in said newspaper, the corporation shall be dissolved.

Whenever all the stockholders, having voting power, shall consent in writing, either in person or by duly authorized attorney, to a dissolution, no meeting of stockholders shall be necessary, but on filing such consent in the office of the Secretary of State, he shall, as above provided, issue a certificate of dissolution, which shall be published as above provided. In the event that such consent is signed by an attorney, the original power of attorney or a photostatic copy thereof shall be attached to and filed with such consent.

Whenever the Secretary of State issues a certificate of dissolution it shall be recorded in the office of the Recorder of the County in which the principal office of the corporation was maintained.

This section shall apply only to proceedings for dissolution in which the resolution by a majority of the whole board of directors is adopted after the date of the approval of this Act. All proceedings for dissolution in which the resolution by a majority of the whole board of directors is adopted on or prior to the date of the approval of this Act shall be governed by the law in force immediately prior to the approval of this Act, which as to such proceedings and only such proceedings is continued in force and effect.

Sec. 42. *Continuation of Corporation After Dissolution for Purposes of Suit, Etc.:*—All corporations, whether they expire by their own limitation, or are otherwise dissolved, shall nevertheless be continued for the term of three years from such expiration or dissolution bodies corporate for the purpose of prosecuting and defending suits by or against them, and of enabling them gradually to settle and close their business, to dispose of and convey their property, and to divide their capital stock but not for the purpose of continuing the business for which said corporation shall have been established; provided, however, that with respect to any action, suit, or proceeding begun or commenced by or against the corporation prior to such expiration or dissolution and with respect to any action, suit or proceeding begun or commenced by or against the corporation within

three years after the date of such expiration or dissolution, such corporation shall only for the purpose of such actions, suits or proceedings so begun or commenced be continued bodies corporate beyond said three-year period and until any judgments, orders, or decrees therein shall be fully executed.

1. EFFECT OF DISSOLUTION

"When a corporation is dissolved by expiration of the time limited in its charter, by a voluntary surrender of its charter, by a judgment forfeiting its charter, or in any other mode, it ceases to exist unless there is some statutory provision continuing its existence. It no longer has capacity or power to enter into contracts, to take, hold, or convey property to sue or be sued, or to exercise any other power. By statutes in most states its existence continues for windup purposes and the directors in office at the time of dissolution as statutory trustees or as directors are empowered to collect the assets, pay liabilities and distribute the surplus to the shareholders. Suits may be brought, continued or defended by them in the corporate name or in their own and other acts may be done so far as necessary for winding up the corporate enterprise." Ballantine, On Corporations, (Rev.Ed., Callaghan & Co., 1946) 722.

2. LIABILITY OF SHAREHOLDERS AND DIRECTORS FOR IMPROPER DISTRIBUTION

PIERCE et al. v. UNITED STATES.

Supreme Court of the United States, 1921. 255 U.S. 398, 41 S.Ct. 365.

Appeal from a decree of the Circuit Court of Appeals affirming a decree of the District Court in favor of the United States in a creditor's suit, brought by the Government against stockholders to satisfy a fine recovered from their corporation.

MR. JUSTICE BRANDEIS delivered the opinion of the court.

In 1907 the Waters Pierce Oil Company, a Missouri corporation, was indicted in the District Court of the United States for the Western District of Louisiana under the Elkins Act (February 19, 1903, c. 708, § 2, 32 Stat. 847), for receiving rebates. In 1913 the Company sold and transferred all its property to the Pierce Oil Corporation; all the proceeds were paid to Henry S. Priest and Clay Arthur Pierce as trustees; and they distributed the same among the stockholders. Of these Henry Clay Pierce and the Pierce Investment Company, received millions in cash and stock and Clay Arthur Pierce a small amount. In 1914 the case under the Elkins Act was tried. The Company was convicted and sentenced to pay a fine of $14,000, and in the following year the judgment was affirmed by the Circuit Court of Appeals. 222 F. 69. An execution issued thereon to the marshal for that district and was returned *nulla bona*. Thereafter this bill in equity was brought by the United States in the Federal District Court for the Eastern District of Missouri against the Waters Pierce Oil Company, the trustees, and these three stockholders to obtain

satisfaction of the judgment out of the money remaining in the hands of the trustees and that received by these stockholders. The District Court entered a decree dismissing the bill as against the Waters Pierce Company and the trustees, but granted, as against the stockholders named, the relief prayed by the Government. The decree was affirmed by the Circuit Court of Appeals for the Eighth Circuit, one judge dissenting. The case is brought here by these defendants, under § 241 of the Judicial Code. Reversal is sought on several grounds.

First. The ground for reversal most strongly urged is that the judgment imposing a fine on the Waters Pierce Company is not a debt on which a creditor's bill will lie. * * *

By § 1041 of the Revised Statutes it is provided (in addition to the power existing by general usage to commit a defendant to jail until his fine has been paid, see Ex parte Barclay, 153 F. 669) that judgments for penalties "may be enforced by execution against the property of the defendant in like manner as judgments in civil cases are enforced." The statute applies to all judgments for penalties, whether recovered by civil or criminal proceedings. A judgment creditor's bill is in essence an equitable execution comparable to proceedings supplementary to execution. See Ex parte Boyd, 105 U.S. 647. The law which sends a corporation into the world with the capacity to act imposes upon its assets liability for its acts. The corporation cannot disable itself from responding by distributing its property among its stockholders and leaving remediless those having valid claims. In such a case the claims after being reduced to judgments may be satisfied out of the assets in the hands of the stockholders. There is no good reason why the rule should be limited to judgments arising out of civil proceedings. * * *

Second. It is contended that the right to bring a creditor's bill did not exist, because the judgment against the Company was not entered in the trial court until a year after the company had divested itself of the property sought to be reached in this suit; and the Government did not become a creditor, at all events until after its claim for penalties had ripened into a judgment. But when a corporation divests itself of all its assets by distributing them among the stockholders, those having unsatisfied claims against it may follow the assets, although the claims were contested and unliquidated at the time when the assets were distributed. It is true that the bill to reach and apply the assets distributed among the stockholders cannot, as a matter of equity jurisdiction and procedure, be filed until the claim has been reduced to judgment and the execution thereon has been returned unsatisfied, Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371, 14 S.Ct. 127; but, as a matter of substantive law, the right to follow the distributed assets (see Railroad Co. v. Howard, 7 Wall. 392, 409; Northern Pacific Ry. Co. v. Boyd, 228 U.S. 482, 33 S.Ct. 554; Kansas City Southern Ry. Co. v. Guardian Trust Co., 240 U.S. 166, 36 S.Ct. 334) applies not only to those who are creditors in the commercial sense, but to all who hold unsatisfied claims. A corporation cannot by divesting itself of all property leave remediless the holder of a contingent claim, or the obligee of an executory

contract, Baltimore & Ohio Telegraph Co. v. Interstate Telegraph Co., 54 F. 50, or the holder of a claim in tort, Hastings v. Drew, 76 N.Y. 9; Jahn v. Champagne Lumber Co., 157 F. 407; and there is no good reason why the United States with a claim for penalties should be in a worse plight. Here the stockholders receiving the assets are in the position of volunteers; and there is not even the excuse that they were ignorant of the Government's claim. They were officers of the corporation, and the indictment was pending when the transfer of the assets was made. See Baltimore & Ohio Telegraph Co. v. Interstate Telegraph Co., supra. * * *

3. EQUITABLE LIMITATIONS ON THE RIGHT TO DISSOLVE

KAVANAUGH v. KAVANAUGH KNITTING CO., Inc.

Court of Appeals of New York, 1919. 226 N.Y. 185, 123 N.E. 148.

COLLIN, J. The plaintiff a minority stockholder in the defendant corporation, seeks a judgment enjoining the individual defendants, as directors of and majority stockholders in the corporation, from continuing the proceeding instituted, by the resolution of the directors, under section 221 of the General Corporation Law (Consol. Laws, c. 23) to dissolve the corporation and declaring void the resolution. The Special Term, upon the application of the defendants, made upon the pleadings by its order, which the Appellate Division has affirmed, dismissed his complaint. The question certified to this court by the order of the Appellate Division permitting the appeal is: "Does the complaint state facts sufficient to constitute a cause of action?"

The facts alleged in their substance and effect are: In December, 1912, the plaintiff and the defendants Kavanaugh organized, under the laws of this state, the defendant corporation, as a business corporation, with themselves as equal owners of the authorized 3,000 shares of its capital stock, and its sole directors. Such ownership of the stock shares has remained except the defendant Frederick W. Kavanaugh transferred on February 28, 1918, 5 shares to the defendant Button, qualifying him for directorship. The corporation has been exceedingly prosperous. Charles H. Kavanaugh has continuously been its president, Frederick W. Kavanaugh its secretary and treasurer until February, 1918, and, until May, 1917, the plaintiff its vice president. In May, 1917, at a special meeting of the stockholders, caused by the defendants Kavanaugh to be called for the purpose, the by-laws were so amended as to provide that a majority, instead of all, as originally provided, of the directors should constitute a quorum at any meeting of the directors, and the board of directors by a majority vote could remove any officer of the company, either with or without cause, at any regular or special meeting of the board. The last provision was adopted by the votes of the defendants Kavanaugh with the avowed purpose of forcing the plaintiff to resign, under threat of removal, from the office of vice president. The plaintiff thereupon resigned as vice president. At

a regular meeting of the board of directors in June, 1917, the defendants Kavanaugh adopted a resolution whereby the compensation of each of the president and the secretary and treasurer was fixed at 20 per cent. of the corporate net earnings to date from January 1, 1917, before charging of any sum for depreciation of corporate property, that is, for the year 1917 at $89,526.20. The plaintiff had no knowledge or notice of the adoption of this resolution until about January 30, 1918. At the annual meeting of the stockholders in January, 1918, the defendants Kavanaugh elected the individual defendants directors. The defendant Button then was not a stockholder in, and for some years previous had been a bookkeeper for, the corporation. Thereupon Frederick W. Kavanaugh was elected vice president and treasurer and Button secretary of the corporation, and the compensation to the president, Charles H. Kavanaugh, and to the treasurer, Frederick W. Kavanaugh, of the year 1917 was continued for the year 1918. Upon the demand of the plaintiff that the resolutions so fixing the compensation be rescinded, the defendants Kavanaugh caused a resolution to be adopted at a special meeting of the stockholders approving the resolutions fixing the compensation to Frederick W. Kavanaugh, except the compensation for 1917 should be calculated from June 11, 1917, instead of from January 1, 1917. Frederick W. Kavanaugh did not vote the 995 shares owned by him. The 5 shares transferred by him to Button and the 1,000 shares owned by Charles H. Kavanaugh were voted in favor of the resolution. The shares of the plaintiff were voted against it. No action was taken concerning the compensation of Charles H. Kavanaugh. The compensation so voted is unfair and unreasonable, and enormously greater than is paid for similar services by similar or greater corporations. On April 15, 1918, the plaintiff began an action in the Supreme Court against those who are the defendants in this action to secure a judgment which, among other things, would declare void the resolutions fixing, and enjoin the payment of, the compensation so voted, or any compensation in excess of such sum as represented the reasonable and fair value of the services rendered by Charles H. Kavanaugh and Frederick W. Kavanaugh respectively. On April 26, 1918, the individual defendants, at a meeting of the board of directors, instituted the proceedings provided by section 221 of the General Corporation Law to dissolve the corporation. The directors then well knew the corporation was exceedingly prosperous and making enormous net profits. The corporation had contracts on hand for the year 1918, the performance of which would call for practically the entire output of its plant, and the net profit would in all likelihood be equal to, if not in excess of, the net profit for the year 1917. The board of directors did not adopt the resolution instituting the dissolution proceeding as the result of or through a bona fide and honest consideration of the facts affecting the general interests of the corporation and its stockholders, but in affirmative bad faith and for the sole purpose of permitting the defendants Charles H. Kavanaugh and Frederick W. Kavanaugh to dissolve the same against the will and desire of the plaintiff and for the purpose of

depreciating the value of the corporate property and of the plaintiff's proportional interest therein. * * *

In the case at bar the persons whose votes as directors adopted the resolution advising the dissolution of the corporation are stockholders holding two-thirds of the stock of the corporation. Undoubtedly no trust relation ordinarily exists between the stockholders themselves or between the stockholders and the corporation, because the stockholders ordinarily are strangers to the management and control of the corporation business and affairs. The directors, generally speaking, are the exclusive executive representatives of the corporation, and are charged with the administration of its internal affairs and the management and use of its assets. The ordinary trust relation of the directors to the corporation and stockholders is not a matter of statutory law, or of technical law. It springs from the fact that the directors have the control and guidance of the corporate business, affairs, and property, and hence of the property interests of the stockholders. Equity, at least, recognizes the truth that the stockholders are the proprietors of the corporate interests and are ultimately the only beneficiaries thereof. Those interests are, in virtue of the law, intrusted, through the corporation, to the directors, and from that condition arises the trusteeship of the directors with the concomitant fiduciary obligations. The section 221 imposes upon the stockholders the ultimate determination of the important question whether or not the corporation shall be dissolved forthwith. The stockholders are bound to determine and control this particular part of the corporate affairs, in regard to which they occupy a relation of trust as between themselves and the corporation, and are burdened and restricted by fiduciary obligations. When a number of stockholders constitute themselves, or are by the law constituted, the managers of corporate affairs or interests, they stand in much the same attitude towards the other or minority stockholders that the directors sustain generally towards all the stockholders, and the law requires of them the utmost good faith. Farmers' Loan & Trust Co. v. New York & Northern Railway Co., 150 N.Y. 410, 430, 44 N.E. 1043, 34 L.R.A. 76, 55 Am.St.Rep. 689; White v. Kincaid, 149 N.C. 415, 63 S.E. 109, 23 L.R.A.,N.S., 1177, 128 Am.St.Rep. 663; Ervin v. Oregon Ry. & Nav. Co. (C.C.) 27 F. 625. In taking corporate action under the statute, the stockholders are acting for the corporation and for each other, and they cannot use their corporate power in bad faith or for their individual advantage or purpose. J. H. Lane & Co. v. Maple Cotton Mills, 226 F. 692, 141 C.C.A. 448. In the instant case the consent of those who constitute the board of directors, expressed at the meeting of the stockholders held under the statute in favor of the dissolution will effect it. Ordinary intelligence does not permit the presumption that they hold two contradicting and mutually destructive opinions or that they as stockholders would destroy the proceeding which they as directors had instituted. The trust relation will rest upon them in the meeting of the stockholders and will be violated, in the absence of restraint, by the bad faith, the self-interests, and wrongful intent which the complaint avers induced their action as directors.

A court of equity will protect a minority stockholder against the acts or threatened acts of the board of directors or of the managing stockholders of the corporation, which violate the fiduciary relation and are directly injurious to the stockholders. The statute empowers the directors and stockholders, under the prescribed procedure, to dissolve the corporation. The plaintiff took his stock subject to the provisions of the statute. Judicial authority does not extend to enjoining the exercise of a right conferred by legislative authority. The courts cannot pass upon the question of the expediency of the dissolution; for that is the very question which the Legislature has authorized the board of directors and the stockholders to decide. They can, however, and will, whenever the facts presented to them in the appropriate action demand, inflexibly uphold and enforce, in accordance with established equitable principles, the obligations of the fiduciary relation. The good faith of the individual defendants is a proper and fundamental subject to be adjudged. Bad faith, fraud, or other breach of trust constitutes a foundation for equitable relief. * * *

The orders should be reversed, with costs in all courts, and motion denied, with costs, and the questions certified answered in the affirmative.

APPENDIX

NEW YORK STOCK CORPORATION LAW

Sec. 36. Changes in respect to shares, capital stock or capital. A stock corporation may effect one or more of the following purposes:

(A) To increase or reduce the amount of its capital stock where all of the capital stock is divided into shares having a par value;

(B) To increase or reduce the par value of any of its shares that have a par value;

(C) To authorize new shares of any class, with or without par value, and the issuance from time to time in one or more series of the shares of any class which is preferred as to dividends or assets subject to the limitations prescribed in section eleven, or to eliminate any previously authorized shares;

(D) To change all or any of its previously authorized shares with or without par value, issued or unissued, into the same or a different number of shares of any class or classes or any series of any class or classes, either with or without par value, or into the same or a different number of both shares with par value and shares without par value, of any classes or series of any class or classes, and at its option by such change to add, alter or take away such rights as could be added, altered or taken away in a proceeding under paragraph (E) of this section;

(E) To classify or reclassify any shares, whether with or without par value. The creation, alteration or abolition, in whole or in part, of designations, preferences, privileges or voting powers of any shares previously authorized, or the restrictions or qualifications thereof (including the creation, alteration or abolition of any provisions or rights in respect of (a) the redemption of any shares, or (b) any cumulative or non-cumulative dividends, whether or not accrued, which shall not have been declared, or (c) any accumulated but unexpended installment of any sinking fund whether or not set aside for the redemption or purchase of any shares, or (d) any preemptive right to subscribe for shares or other securities of the corporation whether existing at law or contained in the certificate of incorporation or other certificate filed pursuant to law), shall be deemed to be a classification or reclassification of such shares for the purpose of this section and of sections thirty-seven and fifty-one, if effected under this paragraph (E) or paragraph (D) or by a reduction in the par value of such shares under paragraph (B);

(F) To change the statements respecting its capital, contained in its certificate of incorporation or other certificate filed pursuant to law, if the corporation be authorized to issue shares without par value;

(G) To reduce its capital so as to eliminate therefrom any or all of the amount thereof previously transferred thereto by resolution of the directors; or, if desired, and without limitation of the corporation's power to reduce its capital in any other lawful manner, to reduce such capital to a specified amount in connection with any change,

reduction of par value or elimination of shares, or other proceeding to be accomplished by the certificate: * * *

Sec. 37. Subscription and authentication of certificate. A certificate filed pursuant to section thirty-six shall be either:

1. Subscribed and acknowledged by every subscriber of the certificate of incorporation and every subscriber to stock, and shall have annexed an affidavit by one of the subscribers of the certificate of incorporation to the effect that no stock has been issued and that the persons who have executed the certificate constitute all of the subscribers of the certificate of incorporation and all of the subscribers to stock; or

2. Subscribed and acknowledged, in person or by proxy by the holders of record of all of the outstanding shares of the corporation entitled to vote with relation to the proceedings provided for in the certificate, and shall have annexed an affidavit of the secretary or an assistant secretary, or in the case of a banking corporation which does not have a secretary or an assistant secretary, of the cashier or an assistant cashier, that the persons who have executed the certificate, in person or by proxy, constitute the holders of record of all of the outstanding shares of the corporation entitled to vote with relation to the proceedings provided for in the certificate; or

3. Subscribed and acknowledged by the president or a vice-president and the secretary or an assistant secretary, except in the case of a banking corporation which does not have a secretary or an assistant secretary, in which case it shall be subscribed and acknowledged by the president or a vice-president and the cashier or an assistant cashier. Such officers shall make and annex an affidavit stating:

(a) That they have been authorized to execute and file such certificate by the votes, cast in person or by proxy, of the holders of record of a majority of the outstanding shares entitled to vote at the stockholders' meeting at which such votes were cast, with relation to the proceedings provided for in the certificate, if the change be made under subdivision (A), (C) or (G) of section thirty-six, except as provided in the next paragraph;

(b) That they have been authorized to execute and file such certificate by the votes, so cast, of the holders of record of two-thirds of the outstanding shares entitled to vote at the stockholders' meeting at which such votes were cast, with relation to the proceedings provided for in the certificate, if the change is made under subdivision (C) of section thirty-six and authorizes the issuance of shares without par value by a corporation not theretofore authorized to issue shares without par value or authorizes the issuance of shares with par value by a corporation not theretofore authorized to issue shares with par value, or if the change is made under any subdivision of section thirty-six except (A), (C) or (G);

(c) If such certificate classifies or reclassifies outstanding shares of any class, or authorizes shares having preferences which are in any respect superior to the preferences of the outstanding shares of

any class having preferences, or provides that shares of any class may be converted into shares of any other class or into shares of any other series of the same class, or alters the terms or conditions of shares of any class which are either convertible or issuable upon conversion, that they have also been authorized to execute and file the same by the votes, cast in person or by proxy, of the holders of record of two-thirds of the outstanding shares of each class which will be adversely affected by the proceedings provided for in the certificate and which was entitled to vote at the stockholders' meeting at which such votes were cast with relation to such proceedings; and

(d) That such votes were cast at a stockholders' meeting held on a date specified, upon notice pursuant to section forty-five of the stock corporation law.

4. [*Reduction of capital.*] If the amount of the capital be reduced by such certificate, or if issued shares be reduced as to par value or eliminated thereby, there shall be annexed thereto an affidavit of the president or a vice-president and also an affidavit of the treasurer or of a majority of the directors, stating either (a) that no distribution of assets to the stockholders will be made in connection with the proposed reduction, or (b) that the actual value of the assets of the corporation is not less than the total amount of the debts and liabilities of the corporation plus the proposed amount of its capital.

5. [*Increase of aggregate par value*]. If the aggregate par value of the issued shares having par value be increased by such certificate, there shall be annexed thereto an affidavit of the president or a vice-president and also an affidavit of the treasurer or an assistant treasurer or of a majority of the directors, stating that by resolution of the directors a sum at least equal to the amount of such increase has been transferred from surplus to capital.

Sec. 38. Provisions applicable to one or more proceedings under sections twenty-eight and thirty-six. The following provisions shall be applicable to a certificate under section twenty-eight or section thirty-six. * * *

3. [*Filing certificates.*] The certificate shall be filed in the office of the secretary of state, * * * and in every case a certified copy thereof or a duplicate original shall be filed in the office of the clerk of the county wherein the office of the corporation is located.

4. [*Disposition of reduced capital.*] No corporation, except as otherwise provided by law, shall make any distribution of its assets in connection with the reduction of its capital or the reduction of the par value or the elimination of any of its issued shares if the effect of such distribution will be to reduce the actual value of its assets to an amount less than the total amount of its debts and liabilities plus the amount, as reduced, of its capital. * * *

6. [*Sale of no par value shares.*] Shares without par value authorized pursuant to such section shall be sold for the consideration prescribed by the certificate authorizing the issuance of such shares; but in the absence of such a provision, the corporation, in accordance with section twelve, may sell its authorized shares without par value which are not substituted for outstanding shares.

7. [*Statement of capital.*] In case of every change of shares the provisions of the certificate of incorporation relating to the capital of the corporation must be complied with. If after the filing of the certificate the corporation is to have the statement respecting capital prescribed in paragraph B of subdivision four of section twelve of this chapter, in computing the capital the amount deemed to have been received for the issuance of shares without par value resulting from a change of previously authorized and issued shares shall be the amount of capital theretofore represented by the shares so changed or, if desired, any less amount stated in the certificate. No corporation which is to have such statement respecting capital shall change previously issued shares into both shares with par value and shares without par value unless the capital represented by the shares so changed exceeds the par value of the shares having par value resulting from such change; and the amount of such excess, or any less sum specified in the certificate, shall be deemed to have been received by the corporation for the issuance of the shares without par value resulting from such change.

8. [*Effect on personal liabilities.*] Except as any such liability shall be altered, eliminated or abolished by such certificate in accordance with the provisions of section thirty-six, the liability of the corporation, its officers, directors and stockholders for corporate debts contracted or obligations incurred prior to the filing of such certificate, shall be unaffected thereby, but for the purpose of enforcing and recovering upon any claim a creditor shall have the same right of recourse against the corporation, its officers, directors and stockholders that he would have had if such certificate had not been filed.

9. [*Appraisal of stock—objecting stockholders.*] If the certificate

(a) alters or abolishes any preferential right of any outstanding shares having preferences, affecting the holders of such shares adversely; or

(b) creates, alters or abolishes any provision or right in respect of the redemption of any outstanding shares or of any sinking fund for the redemption or purchase of any such shares, affecting the holders of such shares adversely; or

(c) limits or denies any pre-emptive right of the holders of any outstanding shares to subscribe for shares or other securities of the corporation, or alters or abolishes any provision affecting any such right contained in the certificate of incorporation or other certificate filed pursuant to law, so as to affect adversely the pre-emptive right of such holders; or

(d) abolishes any voting right of the holders of shares of any class or limits their voting rights, except as the same may be limited by the voting rights given to new shares of any class authorized by the certificate;

any holder of any such shares not in favor of such action may at any time prior to the vote authorizing such action—or if notice of the meeting to vote upon such action was not mailed to stockholders entitled to receive such notice at least twenty days prior to the taking of such vote, then within twenty days after the mailing of such notice

—object to such action and demand payment for his stock, and thereupon such stockholder or the corporation shall have the right, subject to the conditions and provisions of section twenty-one, to have such stock appraised and paid for as provided in said section. Such objection and demand must be in writing and filed with the corporation. If the action is effected without a meeting, the time of such stockholder to file his objection and demand shall expire on the twentieth day after the mailing to such stockholder of a notice stating the nature of such action and the date on which a certificate pursuant to section thirty-six and executed as prescribed by subdivision two of section thirty-seven was filed.

10. [*Increase of aggregate par value.*] No corporation, except as otherwise provided by law, shall file such a certificate increasing the aggregate par value of its issued shares having par value, unless prior thereto the directors have by resolution transferred from surplus to capital a sum at least equal to the amount of such increase.

11. [*Changes not effecting issue of new class.*] Any changes that may be made in the designations, preferences, privileges or voting powers of the shares of any class previously authorized having preferences, or the restrictions or qualifications thereof, by the filing of any certificate which does not eliminate such shares or change them into shares of another class, shall not for the purpose of any statute or rule of law be deemed to effect an issue of a new class of stock.

DELAWARE GENERAL CORPORATION LAW

Sec. 26. Certificate of Incorporation; How Amended; When Corporation Has Capital Stock; When Corporation Has No Capital Stock:—Any corporation of this State existing prior to the tenth day of March, 1899, whether created by Special Act, or general law, or any corporation created under the provisions of this Chapter, may, from time to time, when and as desired, amend its Certificate of Incorporation by addition to its corporate powers and purposes, or diminution thereof, or both; or by substitution of other powers and purposes, in whole or in part, for those prescribed by its Certificate of Incorporation; or by increasing or decreasing its authorized capital stock or reclassifying the same, by changing the number, par value, designations, preferences, or relative, participating, optional, or other special rights of the shares, or the qualifications, limitations or restrictions of such rights, or by changing shares with par value into shares without par value, or shares without par value into shares with par value either with or without increasing or decreasing the number of shares; or by changing its corporate title; or by making any other change or alteration in its Certificate of Incorporation that may be desired, and any or all such changes or alterations may be effected by one certificate of amendment; provided that every Certificate of Incorporation as so amended, changed or altered, shall contain only such provisions as it would be lawful and proper to insert in an original Certificate of Incorporation made at the time of making such amendment.

Whenever issued shares having par value are changed into the same or a greater or less number of shares without par value, whether of the same or of a different class or classes of stock, the aggregate amount of the capital of the corporation represented by such shares without par value shall be the same as the aggregate amount of capital represented by the shares so changed; and whenever issued shares without par value are changed into other shares without par value to a greater or less number, whether of the same or of a different class or classes, the amount of capital represented by the new shares in the aggregate shall be the same as the aggregate amount of capital represented by the shares so changed. The certificate of amendment of any Certificate of Incorporation effecting any change in the issued shares of the corporation shall set forth that the capital of the corporation will not be reduced under or by reason of said amendment.

Every such amendment shall be made and effected in manner following, to-wit:

1. If the corporation has a capital stock, its Board of Directors shall adopt a resolution setting forth the amendment proposed, declaring its advisability, and calling a meeting of the stockholders entitled to vote in respect thereof, for the consideration of such amendment. Said meeting shall be called and held upon such notice as the certificate of incorporation or by-laws of the corporation shall provide, or, in the absence of such provision, upon notice thereof to each stockholder so entitled to vote, either delivered to such stockholder or mailed to him, at his postoffice address, if known, at least ten days before the date fixed for said meeting, said notice to set forth such amendment in full or a brief summary of the changes to be effected thereby, as the directors shall deem advisable. At said meeting a vote of the stockholders so entitled to vote, by ballot, in person or by proxy, shall be taken for and against the proposed amendment, which vote shall be conducted by two Judges appointed for the purpose, either by the directors or by the said meeting. Said Judges shall decide upon the qualifications of voters, and accept their votes, and when the vote is completed, count and ascertain the number of shares voted respectively for and against the amendment, and shall declare whether the persons or bodies corporate holding the majority of the voting stock of said corporation (or of each class of stock entitled to vote thereon, when such vote is to be taken by classes) have voted for or against the proposed amendment; and shall make out a certificate accordingly, stating the number of shares of stock, issued and outstanding and entitled to vote thereon, and the number of shares voted for and the number of shares voted against the amendment respectively, and shall subscribe and deliver said certificate to the Secretary of the corporation. If it shall appear by said Certificate of the Judges that the persons or bodies corporate holding the majority of the stock of said corporation entitled to vote (or of each class of stock when such vote is to be taken by classes) have voted in favor of the amendment, a certificate setting forth the amendment and certifying that such amendment has been duly adopted in accordance with the provisions of this Section shall be made under the seal of the corporation and signed by its President or a Vice-President, and

its Secretary or an Assistant Secretary and the President or such Vice-President shall acknowledge the said certificate before an officer authorized by the laws of Delaware to take acknowledgments of deeds; and the said certificate, so executed and acknowledged shall be filed in the office of the Secretary of State, and a copy thereof, certified by said Secretary of State, shall be recorded in the office of the Recorder of the County in which the original Certificate of Incorporation is recorded; or if the corporation shall have been created by special public act of the Legislature, then said certificate shall be recorded in the office of the Recorder of any County where the business of the said corporation may be conducted. And upon so filing and recording the same, the Certificate of Incorporation of said corporation shall be deemed to be amended accordingly; provided, however, that if any such proposed amendment would alter or change the preferences, special rights or powers given to any one or more classes of stock, by the Certificate of Incorporation, so as to affect such class or classes of stock adversely, or would increase or decrease the amount of the authorized stock of such class or classes of stock, or would increase or decrease the par value thereof, then the holders of the stock of each class of stock so affected by the amendment shall be entitled to vote as a class upon such amendment, whether by the terms of the Certificate of Incorporation such class be entitled to vote or not; and the affirmative vote of a majority in interest of each such class of stock so affected by the amendment shall be necessary to the adoption thereof, in addition to the affirmative vote of a majority of all other stock entitled to vote thereon; and provided, further that the amount of the authorized stock of any such class or classes of stock may be increased or decreased by the affirmative vote of the holders of a majority of the stock of the corporation entitled to vote, if so provided in the original Certificate of Incorporation or in any amendment thereto which created such class or classes of stock or in any amendment thereto which was authorized by a resolution or resolutions adopted by the affirmative vote of the holders of a majority of such class or classes of stock. * * *

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